PRESENT STATUS OF NPAs IN INDIAN PUBLIC SECTOR BANKS

DISSERTATION

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
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MASTER OF AGRICULTURAL ECONOMICS
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SUBMITTED BY

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TO MY PARENTS,
AND
IN MEMORY OF MY BROTHER

DEPARTMENT OF AGRICULTURAL ECONOMICS & BUSINESS MANAGEMENT

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TO WHOM IT MAY CONCERN

This is to certify that dissertation entitled ***"Present status of NPAs in Indian Public sector Banks"*** has been completed by **Mr. Kafeel Ahmad Khan** under my supervision. I have allowed him to submit it in partial fulfillment of the requirement for the degree of Master of Agricultural Economics and Business Management (MAEBM).

To the best of my knowledge and belief that the work has been done by the candidate himself.

I wish him good luck for future endeavor.

(Dr. Rais Ahmad)
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Responsibility for the opinion expressed and for any errors in this report is entirely my own.

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(Kafeel Ahmad Khan)

ABSTRACT

In this an attempt has been made to analytically evaluate the cause for formation and perpetuation of high levels of NPAs in Indian public sector banks (PSBs) and what is its present status. It points out that a high degree of arbitrariness is involved in defining NPAs as it fails to capture diversity in terms of the seasonal and cyclical nature of the economic activities in India. It is highlighted that the use of a secondary asset market may take care of NPA problem, but it requires a number of conditions for its use, which hardly exist in India. The study observes a number of reasons of generation of NPAs such as high share of lending to priority sector, absence of adequate security, legal environment, low level of expertise, repeated lending to same person with similar dubious characteristics, lack of vision of bank in sanctioning, reviewing and enhancing credit limits, political interference, diversion of funds by borrowers, inefficient monitoring over use of funds. While one set of policies granting greater autonomy to the PSBs are proved to be quite effective in restricting formation of fresh NPAs, the other set of policies designed to recover loans, after default, have failed to deliver the goods. It is expected that concerned institutions will work out their strategic response in keeping with the broad thrust of early recognition of the problem, identifying borrowers with genuine intent, timeliness and adequacy of response, effective management. in a highly competitive environment, banks have to address to the following changes in this critical area: manpower planning, talent management, awareness development, well-developed capital markets. Institutions are very difficult to change – it not only requires stringent punitive enactment and vigilance, but also public awareness, campaign and reforming electoral colleagues. Political forces to induce default must be contained. Finally, it concludes by making an assessment of the existing institutions and highlights the fact that the incidence of NPA is as much due to the malfunctioning of the banking institutions as due to the external institutional environment.

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1.1 INTRODUCTION

The modern banking system in India started with establishment of the first joint stock bank- the General Bank of India in 1876. After this first bank, Bank of Hindustan and Bengal Bank came to existence. In the middle of 19th century East India Company established three banks, The Bank of Bengal in 1809, the Bank of Bombay in 1940 and the Bank of Madras in 1843. These banks were the independent units and called Presidency bank. These three banks amalgamated in 1920 and a new bank, Imperial Bank of India was established. After independence passing the SBI Act 1955 nationalized the Imperial Bank of India. The Reserve bank of India as a central bank was nationalized in 1935. The several new banks such as Punjab National Bank, Bank of Baroda, Canara Bank, Indian Bank, Bank of India etc were established after independence. On July 19, 1969, fourteen major banks nationalized. At present the number of nationalized banks are nineteen. Several banks were allowed to operate as per the guidelines of RBI. At present the PSBs banking system can be classified as follows.

1. Public Sector Banks
RBI, SBI, and its Seven associates. Nationalized Banks (19 in number). Regional rural Banks sponsored by PSBs.

All the types of banks are controlled by the RBI and thereby all the banks have to follow the guidelines of the RBI. Government used banks to provide credit and loans to weaker sections. This led to serious crises of unrecoverable debt. Such unrecoverable debt id called Non- Performing Assets (NPAs).

Non-performing Asset (NPA) has emerged since over a decade as an alarming threat to the banking industry in our country sending distressing signals on the sustainability and endurability of the affected banks. The positive results of the chain of measures effected under banking reforms by the Government of India and RBI in terms of the two

Narasimhan Committee Reports in this contemporary period have been neutralised by the ill effects of this surging threat. It is a sweeping and all pervasive virus confronted universally on banking and financial institutions. The severity of the problem is however acutely suffered by Nationalised Banks, followed by the SBI group, and the all India Financial Institutions.

The severity of the incidence of non-performing assets (NPA henceforth) in Indian public sector banks (PSBs henceforth), noted in the early 1990s, raised a severe hue and cry in various quarters. In fact, the problem started much earlier, which became evident from continued recapitalisation of many PSBs since 1985-86[i]. Whatever be the root cause, malfunctioning of the PSBs increased by the end of the 1980s. This led to the setting up of the Narasimham Committee (1991), which, in fact, identified NPA as one of the possible causes/effects of the malfunctioning of the PSBs. In order to quantify the NPA problem, Narasimham Committee (1991) made it mandatory on the part of the banks to publish annually the magnitude of NPAs. NPAs are those categories of assets (advances, bills discounted, overdraft, cash credits etc) for which any amount remains due for a period of 180 days.[ii] Following the recommendations, banks started publishing in their annual reports NPA data, which were astonishingly high. RBI (1999) report on NPA stated that reduction in NPA should be treated as a 'national priority'. In the Task Force[iii] report on non-performing assets in the Indian financial system, it is argued that three NPA ridden banks (UCO bank, United Bank of India and Indian Bank) are open sores threatening the health of the entire financial system. The report went to the extent of stating

that these banks were not viable candidates either for privatization or for merger, and thus they should be closed down. The Verma Committee (1999), on the other hand, felt that these three banks could be revived if they submit themselves to the discipline of a rigorous restructuring, underpinned with adequate infusion of funds and simultaneous relief from the load of NPA and excess manpower. The difference in the respective recommendations has provoked protests of varying orders of frenzy, from the unionized employees.

The region of operation however matters. This is a very significant contribution to understanding of the phenomenon and the steps to tackle it. The policy implications of the results of the paper are that sustainable reform in the financial sector and improvement in the performing efficiency of domestic banks require improvement in the enforcement environment in some regions of the country. The regional exposure effect would be more transparently evident were banks to report NPAs by state or region instead of merely as a national average as at present. The operating environment matters particularly in the Indian context where there are externally imposed compulsions on banks to enter into and operate in difficult regions. The environmental limits on bank operations cannot be tackled by reforms at bank level alone as will be discussed in a section below. Another paper by Rajaraman and Vasishth (2002) performed panel regression on NPA data of twenty-seven public sector banks covering a five-year period from 1995-96 to 1999-2000. Surprisingly, very few serious attempts have been made to find out the causes or determinants of the NPA in Indian banks. Without such a study, policy recommendations and measures to contain NPA would not be of much use, as evident from the continued poor performance of PSBs in spite of ten years of reforms. The present study makes an attempt to fill up such a gap. Once the root causes of NPA are identified, one can evaluate the policies and find the lacuna therein in order to understand why the pace of improvement in the NPA scenario has been so slow.

1.2 MEANING OF NPAs

An asset is classified as non-performing asset (NPAs) if the borrower does not pay dues in the form of principal and interest for a period of 180 days. However with effect from March 2004, default status would be given to a borrower if dues are not paid for 90 days. If any advance or credit facilities granted by bank to a borrower becomes non-performing, then the bank will have to treat all the advances/credit facilities granted to that borrower as non-performing without having any regard to the fact that there may still exist certain advances / credit facilities having performing status.

In the simple words, an asset, which ceases to yield income, is an NPA. For instance those loan given by a bank or financial institution, where the borrower defaults or delays interest or principle amount payments for two quarters or more.

NPAs suddenly in the Indian Banking scenario, arround the 80s, is the midst of turbulent structural changes overtaking the international banking institutions and when the global financial markets were undergoing sweeping changes. After it emergeed the problem of NPA kept hidden and gradually swelling unnoticed and unpercieved, in the moze of deffective accounting standards rhat still continue with Indian Banks upto 90s and opaque balance sheets.

It's a known fact that the banks and financial institutions in India face the problem of swelling non-performing assets (NPAs) and the issue is becoming more and more unmanageable. In order to bring the situation under control, some steps have been taken recently. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 was passed by Parliament, which is an important step towards elimination or reduction of NPAs.

1.3 THE UNSEEN AND UNPERCEIVED EDGE OF NPAs

NPA surfaced suddenly in the Indian banking scenario, around the Eighties, in the midst of turbulent structural changes overtaking the international banking institutions, and when the global financial markets were undergoing sweeping changes. We have already discussed these changes in detail in an earlier Chapter. In fact after it had emerged the problem of NPA kept hidden and gradually swelling unnoticed and unperceived, in the maze of defective accounting standards that still continued with Indian Banks up to the Nineties and opaque Balance sheets.

In a dynamic world, it is true that new ideas and new concepts that emerge through such changes caused by social evolution bring beneficial effects, but only after levying a heavy initial toll. The process of quickly integrating new innovations in the existing set-up leads to an immediate disorder and unsettled conditions. People are not accustomed to the new models. These new formations take time to configure, and work smoothly. The old is cast away and the new is found difficult to adjust. Marginal and sub-marginal operators are swept away by these convulsions. Banks being sensitive institutions entrenched deeply in traditional beliefs and conventions were unable to adjust themselves to the changes. They suffered easy victims to this upheaval in the initial phase.

The government hastily introduced the first phase of reforms in the financial and banking sectors after the economic crisis of 1991. This was an effort to quickly resurrect the health of the banking system and bridge the gap between Indian and global banking development. Indian Banking, in particular PSBs suddenly woke up to the realities of the situation and to face the burden of the surfeit of their woes. Simultaneously major revolutionary transitions were taking place in other sectors of the economy on account the ongoing economic reforms intended towards freeing the Indian economy from government controls and linking it to market driven forces for a quick integration with the global economy. Import restrictions were gradually freed. Tariffs were brought down and quantitative controls were removed. The Indian market was opened for free competition to the global players. The new economic policy in turns revolutionalised the environment of the Indian industry and business and put them to similar problems of new mixture of opportunities and challenges. As a result we witness today a scenario of banking, trade and industry in India, all undergoing the convulsions of total reformation battling to kick off the decadence of the past and to gain a new strength and vigour for effective links with the global economy. Many are still languishing unable to get released from the old set-up, while a few progressive corporates are making a niche for themselves in the global context.

During this decade the reforms have covered almost every segment of the financial sector. In particular, it is the banking sector, which experienced major reforms. The reforms have taken the Indian banking sector far away from the days of nationalization. Increase in the number of banks due to the entry of new private and foreign banks; increase in the transparency of the banks' balance sheets through the introduction of prudential norms and norms of disclosure; increase in the role of the market forces due to the deregulated interest rates, together with rapid computerisation and application of the benefits of information technology to banking operations have all significantly affected the operational environment of the Indian banking sector.

In the background of these complex changes when the problem of NPA was belatedly recognised for the first time at its peak velocity during 1992-93, there was resultant chaos and confusion. As the problem in large magnitude erupted suddenly banks were unable to analyze and make a realistic or complete assessment of the surmounting situation. It was not realised that the root of the problem of NPA was centered elsewhere in multiple layers, as much outside the banking system, more particularly in the transient economy of the country, as within. Banking is not a compartmentalized and isolated sector delinked from the rest of the economy. As has happened elsewhere in the world, a distressed national economy shifts a part of its negative results to the banking industry. In short, banks are made ultimately to finance the losses incurred by constituent industries and businesses. The unpreparedness and structural weakness of our banking system to act to the emerging scenario and de-risk itself to the challenges thrown by the new order, trying to switch over to globalisation were only aggravating the crisis. Partial perceptions and hasty judgements led to a policy of ad-hoc-ism, which characterised the approach of the authorities during the last two-decades towards finding solutions to banking ailments and dismantling recovery impediments. Continuous concern was expressed. Repeated correctional efforts were executed, but positive results were evading. The problem was defying a solution.

The assessment of the mix-of contributing factors should have included human factors (those pertaining to the bankers and the credit customers), environmental imbalances in the economy on account of wholesale changes and also inherited problems of Indian banking and industry.

While banks functioned for several decades under ethnic culture, Indian business and industry were owned, controlled or managed by single families, all having been nurtured and developed through innovative zeal of pioneers, represented by one dominant individual towering at each set-up. This inherently convey the sole-proprietorship culture and unable to quickly transform to modern professionally managed corporations of the global standard, where operations should be conducted on a decentralized knowledge-based work-group- an integrated teams of specialists each contributing to a core area of management. The Indian management set up everywhere turns mostly as one-man show even today.

Variable skill, efficiency and level integrity prevailing in different branches and in different banks accounts for the sweeping disparities between inter-bank and intra-bank performance. We may add that while the core or base-level NPA in the industry is due to common contributory causes, the inter-se variations are on account of the structural and operational disparities. The heavy concentrated prevalence of NPA is definitely due to human factors contributing to the same.

No bank appears to have conducted studies involving a cross-section of its operating field staff, including the audit and inspection functionaries for a candid and comprehensive introspection based on a survey of the variables of NPA burden under different categories of sectoral credit, different regions and in individual Branches categorized as with high, medium and low incidence of NPA. We do not hear the voice of the operating personnel in these banks candidly expressed and explaining their failures. Ex-bankers, i.e. the professional bankers who have retired from service, but possess a depth of inside knowledge do not out-pour candidly their views. After three decades of nationalised banking, we must have some hundreds of retired Bank executives in the country, who can boldly and independently, but objectively voice their views. Everyone is satisfied in blaming the others. Bank executives hold 'willful defaulters' responsible for all the plague. Industry and business blames the government policies.

An important fact-revealing information for each NPA account is the gap period between the date, when the advance was originally made and the date of its becoming NPA. If the gap is long, it is the case of a sunset industry. Things were all right earlier, but economic variance in trade cycles or market sentiments have created the NPA.

Significant part of the NPA is on account of clout banking or willfully given bad loans. Infant mortality in credit is solely on account of human factors and absence of human integrity.

The credit portfolio of a nationalised bank also includes a number of low-risk and risk-free segments, which cannot create NPA. Small personal loans against banks own deposits and other tangible and easily marketable securities pledged to the bank and held in its custody are of this category. Such small loans are universally given in almost all the branches and hence the aggregate constitutes a significant figure. Then there is food credit given to FCI for food procurement and similar credits given to major public Utilities and Public Sector Undertakings of the Central Government. It is only the residual fragments of Bank credit that are exposed to credit failures and reasons for NPA can be ascertained by scrutinising this segment.

Secondly NPA is not a dilemma facing exclusively the Bankers. It is in fact an all pervasive national scourge swaying the entire Indian economy. NPA is a sore throat of the Indian economy as a whole. The banks are only the ultimate victims, where life cycle of the virus is terminated.

In short, the functional staff of the Bank along with the representatives of business and industry have to accept a candid introspection and arrive at a code of discipline in any final solution. And preventive action to be successful should start from the credit-recipient level and then extend to the bankers. RBI and Government of India can positively facilitate the process by providing enabling measures. Do not try to set right industry and banks, but help industry and banks to set right themselves. The new tool of deregulated approach has to be accepted in solving NPA.

Chapter 2

- ✓ Research Methodology

RESEARCH METHODOLOGY

Objectives of the Study

1. To review the problem of NPAs in public sector banks.
2. To study the Prudential Norms related to NPAs
3. To study the major reasons of arising NPAs.
4. To critically analyse the statistics on Public sector banks.
5. The suggested measures to reduce the NPAs in Public sector banks.

This study is based on **secondary source** of information. The data and information has been collected from various books, reports magazines, and websites.

Limitations:

1. This study is based on the secondary source of information.
2. Study is conducted in short time period.
3. Limited Finance availability.

Chapter 3

- ✓ Prudential Norms Related to NPAs
- ✓ Disclosure Norms for Banks
- ✓ Accounting Procedure for NPAs

2.1 PRUDENTIAL NORMS RELATED TO NPAs

In 1992-93 prudential norms were introduced with greater transparency and securing the long-term sustainability of the banks. Presented below is a profile of those related with income recognition and asset classification.

Income Recognition

Interest income should not be realized until it is realized. An NPA is one where interest is overdue for two quarters or more. In respect of NPAs, interest is not due to be recognized on accrual basis, but is to be treated as income only when it actually received. On Non-Performing accounts the banks should not charge or taken at income unless it realized.

Asset Classification

The banks should classify their asset based on weakness and dependability on collateral securities.

Assets are classified:

Performing assets

Non-Performing assets

Performing asset:

They also known as standard assets and are loans where the interest and /or principle are not overdue beyond 180 days at the end of the financial year. Such loans don't carry more than normal business risk.

Non-Performing Assets

NPAs are those loans given by a bank or financial institution, where the borrower defaults or delays interest or principle payment for two quarters or more.

Classification of NPA

NPA are further classified into

Sub-Standard Asset

Doubtful Asset

Loss Asset

Sub-Standard assets: loans which are not performing for a period not exceeding two years, where the current net worth of borrower or the current market value of the security, against which the loan is taken, is not enough to ensure full recovery of the debt.

Doubtful Assets: Loans, which have remained non-performing for period exceeding two years (18 months, with effect from March 2001).

Loss Assets: Assets, where internal/external auditor has identified loss appointed by RBI, but the amount has not been written off wholly or partly. These assets are classified as unrecoverable and are of little value to the lending institution.

Based on the assets classification, banks have to make the following provisions in their books for advances, which are considered NPAs.

1. **Loss assets**: The entire amount has to be written off. If the assets are to remain in the books for any reason, 100% of the outstanding amount should be provided for.
2. **Doubtful Assets:**
   a) 100% to the extent of which advances is unsecured.
   b) Over and above (a) provision ranging from 20% to 50% of the secured position for which the advances has been considered as doubtful depending upon period given below.
      Upto 1- year old doubtful asset: 20%.
      1-3 year old doubtful asset: 30%.
      Over 3-year-old doubtful asset: 50%.
3. **Sub-standard assets:** A general provision of 10% of the outstanding amount should be made in this category.

Gross NPAs are the total assets outstanding of all the borrowers classified as non-performing assets (viz.- sub-standard, doubtful and loss assets).

Net NPA is the gross NPA minus the gross provision made unrealized interest and unadjusted credit balance with regard to various NPA accounts.

2.2 DISCLOSURE NORM FOR NPAs IN BANKS

Banks and financial insttution (FIs) have been advised to report to RBI deatails of borrowal accounts calssified as doubbtful and loss and suit-filed accounts of Rs. 1 crore and above as on 31 March and 30 September every year, wide circular DBOD No. BC/CIS 47/20.16.002/94 dated April 23, 1994. Further, it was indicated that based on the information so colected, RBI will be publishing in a booklet form the list of suit-filed accounts of Rs. 1 crore and above and an update on a half yaerly basis. Subsequently, banks and Fis were advised to submit, separately, a complete list of suit-filed accounts of Rs. 1 crore and above as on 31 March for publication purposes and quarterly update showing deletion from/addition to the above list complete list of suit-filed accounts as on 31 March is published in bokklet form by RBI, this list and its quarterly updates are available in RBI website.

With a view to avoiding duplication in reporting suit-filed accounts of Rs. 1 crore and above under both suit-filed and under NPA (Doubtful and loss) category, banks and Fis are advised to report, hereafter:

- All non suit-filed doubtful and loss accounts of Rs. 1 crore and above.
- All suit-filed accounts of Rs. 1 crore and
- Quarterly updates of suit-filed accounts.

2.3 ACCOUNTING PROCEDURES FOR NPAs

1. All NPAs accounts, including those with outstading below Rs. 25,000/- and government guaranteed accounts other than protested category should be transferred to a seaprate ledger to be called "NPA ledger" by passing necessary transfer voucher.
2. NPA ledger is to be maintained facility wise.
3. Thew outstanding balance in account as on date of transfer sahll be the opening debit entry in the ladger section and all debit and credits are to be entered and no entry in respect of recorded interest is to be entered in this section.
4. The outstanding balance in the accounts as on the date of transfer shall be the opening entry in the Memoranda Book. Thereafter the interest on quarterly/ half yearly period as the case may be, shall be calculated and posted. All other debit and credit vouchers as are entered in the section shall also be entered in memoranda book.
5. Ledger section of NPA ledger shall reflect balance outstanding without interest element and memoranda record section of NPA ledger shall reflect shall show balance outstanding inclusive recorded interest.

Chapter 4

- ✓ Analysis of NPAs Statistics of PSBs (Except RRBs)
- ✓ Analysis of NPAs Statistics of RRBs
- ✓ Impact of NPA

3.1 ANALYSIS OF NPAs STATISTICS

Non-prforming assets has emerged since over a decade as a alarming threat to the banking industry in the country sending distressing signals on the sustainalibility and endurability of the effected banks. The positive results of the chain of measures effected under banking reforms by the government of India and RBI in terms of the two Narasimhan committee reports in this contemporary period has been neutralized by the ill effects of this surging threat. Despite verious correctional steps administered to solve and end this problem, concrete results are eluding. It is a sweeping and all pervasive virus confronted universally on banking and financial institutions.

Gross NPAs of public sector banks decline As a sign of growing competitiveness in the Indian banking sector, the gross NPAs of public sector banks declined to Rs 54,086 crore in 2002-03, from Rs 56,473 crore in FY 2001-02, Reserve Bank of India said in its Report on Trend and Progress in Banking In India 2002-03.

But the gross NPAs for new private banks rose to Rs 7,232 crore, from Rs 6,821 crore and that of foreign banks increased to Rs 2,829 crore, from Rs 2,469 crore. "The NPAs declined sharply in FY 2002-03, reflecting, inter alia the salutory impact of earlier measures towards NPA reduction and enactment of the Securitisation Act (SARFAESI) Act ensuring prompter recovery without intervention of court or tribunal," RBI said. Since the commencement or enforcement of the SARFAESI Act till end-June 2003, public sector banks have issued 33,736 notices for an outstanding amount of Rs 12,147 crore and have recovered Rs 499.2 crore from 9,946 cases.

Public sector banks have identified NPAs worth over Rs 12,000 crore to be sold to the asset reconstruction companies. However, the process of valuation of the loans prior to sale was yet to be completed, RBI added. State Bank of India has
recovered a meagre Rs 48 crore as against outstandings of Rs 3,974 crore for which it had issued 7,141 notices, the report said.

RBI report showed that Punjab National Bank, Central Bank of India and Oriental Bank of Commerce have issued 3,015 notices, 2,617 notices and 2,217 notices respectively. It also noted that NPAs of the State Bank Group stood at Rs 16,958.1 crore as on end-March 2003 while that of State Bank of India was pegged at Rs 13,257.27 crore. According to the RBI, a major factor contributing to the high level of NPAs in India has been the inadequate legal framework for collecting overdue loans(Table 1).

The most pertinent and alarming cause of concern of the banking sector in India is the amount of Non-performing Assets. Gross NPAs increased to Rs.63,883 crores as at March-end 2001 from Rs.60,408 crores as at March-end 2000. Net NPAs as at March-end 2001 amounted to Rs.32,468 crores as compared to Rs.30,073 crores as at March-end 2000. The ratios of gross and net NPAs to total advances however declined to 11.4% and 6.2% as at March-end 2001 from 12.7% and 6.8% as at March-end 2000 respectively. The gross NPAs of Public Sector banks as at March-end 2001 was Rs.54,773 crores as against Rs.53,033 as at March-end 2000. The share of PSBs in total NPAs of SCBs declined to 85.7% from 87.8% during this period. The ratio of gross NPAs to total advances declined from 14.0% as at March-end 2000 to 12.4% as at March-end 2001 and that of net NPAs to net advances declined from 7.4% to 6.7% during this period.

The reason for increase in NPAs can be attributed to the inability in the existing process of debt recovery, inadequate legal provision on fore-closure and bankruptcy and difficulties in the speedy executions of court decrees. Any solution to this problem requires well-defined long term plan with both short and medium term action plan having specific definition of goals support action and process rather than ad hoc approach.

As per a report compiled by ICRA, the combined net profits of the 27 PSU banks increased by 48 per cent to Rs 12,294 crore in the last fiscal.Net NPAs fell drastically from 5.8 to 4.5 per cent.The capital base of PSU banks increased to Rs 14,175 crore by the end of last fiscal, from Rs 3,034 crore in 1990-91, with all the banks meeting the RBI stipulated 9.0 per cent capital adequacy ratio by March 31, 2003(Table4).

For PSU banks, gross NPAs under priority sector accounted for 44.5 per cent of their entire gross NPAs. In 10 out of 27 PSU banks, priority sector NPAs constituted more than 50 per cent of their gross NPAs.ICRA feel that the securitisation laws and the proposed Credit Information Bureau is expected to help banks in bringing down their NPAs further.

The capital base of PSU banks increased to Rs 14,175 crore by the end of last fiscal, from Rs 3,034 crore in 1990-91, with all the banks meeting the RBI stipulated 9.0 per cent capital adequacy ratio by March 31, 2003. The main reason for improvement in CAR was the Rs 22,500 crore recapitalisation in 19 PSU banks during the last decade.In 2002-03, Canara Bank, PNB, Union Bank and Allahabad Bank raised nearly Rs 937 crore.

As per ICRA report, the combined income of the PSU banks inched up 9.6 per cent to Rs 1,28,464 crore last fiscal. The trend in declining interest rates in the economy resulted in a mere 1.0 per cent increase in Interest Expenses to Rs 69,853 crore. NPAs and taxes resulted in a 30.3 per cent rise in provisions to Rs 17,420 crore.

Taking advantage of loopholes in the old banking law, PSBs developed enough laxity to accumulate a large volume of NPA. It is clear from the figures of NPA that are available for each year since 1993. Gross NPAs in the PSBs have increased rapidly from Rs 39 thousand crores in 1993 to Rs 54 thousand crores in 2003 as shown in table 1. It grew at a rate of around five percent per annum during the period excepting the last year when it declined. Sheer size of NPA and its growth rate over the greater part of the 1990s indicate the ill health of the Indian public sector banks. In the year 1994, it was found that almost a quarter of the total volume of existing advances made by these banks remained non-performing. After implementations of the Narasimham Committee Report (1991) banks could no longer show interest on an accrual basis but it had to make provisioning from its income while granting of advances. This called for recapitalisation of these banks.

Further, recapitalisation was required to a large extent in order to write off bad debts. The total bad debt written off by 27 PSBs in 1997-98 was Rs 2,800 crores. A number of profitable Indian PSBs recorded huge increases in bad debt write offs in 1998-99 as compared to previous years. One more compelling reason for recapitalisation was to enter into capital market[iv]. Since the beginning of banking reforms in the early eighties, the government has contributed Rs 20,046 crores towards recapitalisation and allowed banks to write off Rs 3,978 crores. Clearly, in the pre-reform era, when provisioning was not done, the profits of PSBs were overstated in their accounts. However, it is interesting to note that recapitalisation started as early as 1985-86, as noted by Mathur (2002). This is indicative of the malfunctioning of the banks which started much before Narasimham Committee and continued throughout the nineties (Table 5).

Table 1: Gross and Net NPAs of PSBs (amounts in Rs crores)

End March	Gross NPAs (1)	Gross Advance (2)	(1) as a % of (2) (3)	(1) As a % of tot. Asst (4)	Net NPAs (5)	Net Advance (6)	(5) as a % of (2) (7)	(6) As a % of tot. Asset (8)	Increment in Gross NPAs (9)	Increment in gross Adv. (10)	(9) as a % of (10) (11)	Gross minus net NPA (12)
1993	39,253	169,194	23.2	12	NA	NA	NA	NA	NA	NA	NA	NA
1994	41,041	165,488	24.8	11	NA	NA	NA	NA	1788	-3,706	-48.25	NA
1995	38385	196,846	19.5	8.7	17567	164,178	11	4	-2656	31,358	-8.47	20,818
1996	41661	231,450	18	8.2	18297	205,584	8.9	3.6	3276	34,604	9.47	23,364
1997	43577	244,214	17.8	7.8	20285	220,922	9.2	3.6	1916	12,764	15.01	23,292
1998	45653	284,971	16	7	21232	260,459	8.2	3.3	2076	40,757	5.09	24,421
1999	51710	325,328	15.9	6.7	24211	297,789	8.1	3.1	6057	40,357	15.01	27,499
2000	53033	379,461	14	6	26187	352,714	7.4	2.9	1323	54,133	2.44	26,846
2001	54672	442,134	12.4	5.3	27,977	415,207	6.7	2.7	1639	62,673	2.62	26,695
2002	56473	509,368	11.1	4.9	27958	480,681	5.8	2.4	1801	67,234	2.68	28,515
2003	54086	577,813	9.4	4.2	24963	549,351	4.5	1.9	-2387	68,445	-3.49	29,123

Source: RBI website: www.rbi.org.in

Gross and Net NPAs of PSBs (amounts in Rs crores)

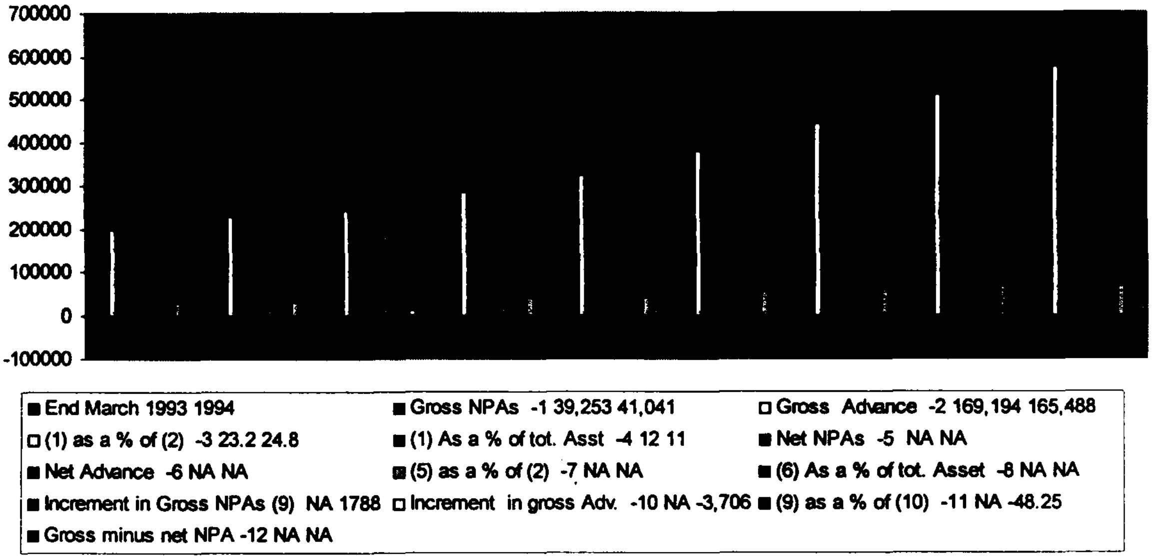


Table 2: Asset classification based on quality (Amount in Rs crores)

Year	1 Standard Assets	2 Sub-standard assets	3 Doubtful assets	4 Loss assets	Total assets	1 as % of total assets	2 as % of total assets	3 as % of total assets	4 as % of total assets
1993	130087	12552	20106	393	163138	76.8	7.4	11.9	2.3
1994	124580	12163	23317	4073	164133	75.2	7.4	14.1	2.4
1995	158967	7758	22913	3732	193370	80.6	3.9	11.6	1.9
1996	189660	9299	24707	4351	228017	82.0	4.0	10.7	1.9
1997	200637	12471	26015	5090	244213	82.2	5.1	10.6	2.1
1998	239318	14463	25819	5371	284971	84.0	5.1	9.1	1.9
1999	273618	16033	29252	6425	325328	84.1	4.9	9.0	2.0
2000	326783	16361	30535	6398	380077	86.0	4.3	8.0	1.7
2001	387360	14745	33485	6544	442134	87.6	3.3	7.6	1.5
2002	452862	15788	33658	7061	509369	88.9	3.1	6.6	1.4
2003	523724	14909	32340	6840	577813	90.6	2.6	5.6	1.2
Growth Rate 1993-2003 (%)	15.86	4.85	5.15	19.04	14.24	NA	NA	NA	NA

*Source: **RBI website: rbi.org.in***

Over the year's bank advances increased much faster rate than that of NPA and thereby reduced the share of gross NPA in gross advances to 14 percent by the end of the decade and close to 9 percent in 2003. In terms of total assets of these banks, it was found that around 11 percent of these assets were non-performing in 1994, this ratio however substantially declined to 6 percent in 2000 and close to 4 percent in 2003. This happened not because of the substantial recovery of NPA but due to a rapid increase in bank advances and assets. Further, as shown in table 1, increment of gross NPA was quite high throughout the period under consideration, excepting in 1995 and 2003[v]. This, in other words, shows that the volume of fresh defaults far exceeded the recovery in these years.

Table 3: NPAs distribution across sectors (Rs crores)

Year	Priority Sector Gross NPA	Non-Priority Sector Gross NPA	Public Sector Gross NPA	Total Gross NPA	Share of Priority Sector NPA in Total (%)	Share of Non-priority Sector NPA in Total (%)	Share of Public Sector NPA in Total (%)
1995	19208	17861	1316	38385	50	46.5	3.4
1996	19106	19067	1411	39584	48.3	48.2	3.6
1997	20776	21340	1461	43577	47.7	49	3.3
1998	21184	23107	1362	45653	46.4	50.6	3
1999	22606	27608	1496	51710	43.7	53.4	2.9
2000	23715	28524	1055	53294	44.5	53.5	2
2001	24156	27307	1711	53174	45.4	51.4	3.2
2002	25139	30251	1116	56506	44.5	53.5	2.0
2003	24938	26781	1087	52807	47.2	50.7	2.1
Growth Rate 1995-2003 (%)	3.88	6.38	-2.32	4.95	NA	NA	NA

Source: ***RBI website: rbi.org.in***

Table 4. Non-Performing Assets as percentage of Advances - Public Sector Banks

(Per cent)									
Sr.	**Name of the Bank**	**Gross NPAs/Gross Advances**				**Net NPAs/Net Advances**			
No.		**1999-2000**	**2000-01**	**2001-02**	**2002-03**	**1999-2000**	**2000-01**	**2001-02**	**2002-03**
1	2	3	4	5	6	7	8	9	10
	Nationalised Banks	**13.91**	**12.16**	**11.01**	**9.72**	**7.80**	**7.01**	**6.01**	**4.77**
1	Allahabad Bank	19.07	17.66	16.94	13.65	12.17	11.21	10.55	7.07
2	Andhra Bank	7.85	6.13	5.26	4.89	3.47	2.95	2.45	1.79
3	Bank of Baroda	14.73	14.11	12.39	11.02	6.95	6.77	5.68	4.81
4	Bank of India	12.89	10.25	9.37	8.55	8.61	6.72	6.01	5.59
5	Bank of Maharashtra	12.65	12.35	10.44	9.55	6.97	7.41	5.81	4.83
6	Canara Bank	9.60	7.48	6.22	5.96	5.28	4.84	3.89	3.59
7	Central Bank of India	16.63	16.06	14.70	13.06	9.84	9.72	7.98	6.74
8	Corporation Bank	5.39	5.40	5.19	5.27	1.91	1.98	2.31	1.65
9	Dena Bank	18.17	25.31	24.11	17.86	13.81	18.29	16.31	11.82
10	Indian Bank	32.77	21.76	17.86	12.39	16.18	10.07	8.28	6.15
11	Indian Overseas Bank	13.18	11.81	11.35	10.29	7.65	7.01	6.32	5.23
12	Oriental Bank of Commerce	5.54	5.21	6.57	6.94	3.61	3.59	3.21	1.44
13	Punjab & Sind Bank	15.27	18.45	18.19	19.25	9.40	12.27	11.68	10.85
14	Punjab National Bank	13.19	11.71	11.38	11.58	8.52	6.69	5.27	3.80
15	Syndicate Bank	7.74	7.87	8.35	8.32	3.17	4.07	4.53	4.29
16	UCO Bank	18.79	11.64	9.59	8.24	8.75	6.30	5.65	4.38
17	Union Bank of India	12.27	11.20	10.77	8.96	7.97	6.86	6.26	4.91

18	United Bank of India	27.63	21.51	16.16	12.15	12.85	10.47	7.94	5.52
19	Vijaya Bank	11.52	10.00	9.39	6.18	6.62	6.22	6.02	2.61
	State Bank Group	**14.08**	**12.73**	**11.23**	**8.68**	**6.77**	**6.27**	**5.45**	**4.12**
20	State Bank of India	14.25	12.93	11.95	9.34	6.41	6.03	5.64	4.49
21	State Bank of Bikaner & Jaipur	16.18	12.91	9.36	8.15	10.14	7.83	5.77	4.16
22	State Bank of Hyderabad	14.18	14.08	10.08	7.28	7.30	7.83	4.96	3.26
23	State Bank of Indore	10.80	9.16	7.18	5.53	7.55	5.91	3.58	2.66
24	State Bank of Mysore	13.89	12.83	12.07	10.14	8.12	7.88	7.36	5.19
25	State Bank of Patiala	10.99	9.66	6.94	4.80	6.09	4.92	2.94	1.49
26	State Bank of Saurashtra	13.71	14.57	10.18	7.32	7.86	6.87	4.95	3.53
27	State Bank of Travancore	14.43	11.38	9.41	6.67	8.80	7.75	5.72	3.05
	Public Sector Banks	**13.98**	**12.37**	**11.09**	**9.36**	**7.42**	**6.74**	**5.82**	**4.54**

Source:

1. Balance sheets of respective banks
2. Returns received from respective banks.

Table 5: Movements of Non-Performing Assets (NPAs) of Scheduled Commercial Banks (EXCLUDING RRBs): 2000-2003

	Gross NPAs				Net NPAs			
Name of the Bank	As on	As on	As on	As on	As on	As on	As on	As on
	March 31,	March 31,	March 31,	March 31,	March 31,	March 31,	March 31,	March 31,
	2000	2001	2002	2003	2000	2001	2002	2003
	(1)	(4)	(1)	(4)	(5)	(6)	(5)	(6)
State Bank of India and its Associates								
State Bank of India	1524629	1587497	1548585	1350607	628399	685626	681028	618300
State Bank of Bikaner & Jaipur	77347	71500	58512	58029	45333	40967	34211	28179
State Bank of Hyderabad	93572	107529	89852	73984	44420	55506	41747	31539
State Bank of Indore	31801	32519	32010	29525	21464	20257	15346	13784
State Bank of Mysore	54981	58101	62461	56201	30110	33230	36151	27290
State Bank of Patiala	66953	69476	36560	37064	35179	33620	25478	16065
State Bank of Saurashtra	46939	56854	44325	35434	25145	26238	20357	16396
State Bank of Travancore	81108	75793	72761	63526	45166	49597	42505	28000
Nationalised								

Banks								
Allahabad Bank	169416	182131	200185	184150	100278	107464	116016	88698
Andhra Bank	45678	47010	52414	58070	19360	21902	23723	20627
Bank of Baroda	389722	418572	448930	416790	168631	185054	191319	170028
Bank of India	346400	343400	372200	380400	220600	213800	230400	238200
Bank of Maharashtra	71679	87663	90642	95754	37047	49767	47971	45914
Canara Bank	233441	224289	211244	247478	124376	134599	128839	145388
Central Bank of India	284300	325300	337600	324400	155500	183000	169900	156200
Corporation Bank	43303	48474	58705	65734	14880	17119	25343	19839
Dena Bank	139960	192826	199602	161658	98317	128031	128031	122725
Indian Bank	335457	235907	217535	162982	132705	94993	90358	75495
Indian Overseas Bank	162280	163140	181854	189648	88537	91758	96751	91221
Oriental Bank of Commerce	52751	58576	95179	114625	33642	39711	45380	22528
Punjab & Sind Bank	77680	102615	109184	124689	44688	63413	65121	63947
Punjab National Bank	312677	346010	413986	498006	191695	187111	181001	152691
Syndicate Bank	99215	107460	129913	142017	..	..	99215	107460
UCO Bank	165141	128402	127537	133265	68388	65592	65088	72359
Union Bank of India	188120	205633	242048	238761	116428	120122	133836	125343
United Bank of India	152037	141115	121550	95908	58724	60230	54199	40606
Vijaya Bank	56719	59492	60269	50554	31016	35606	37324	20581

Source: 1. Balance sheets of respective banks

2. Returns received from respective banks.

Table 6: Top Ten Public Sector banks – NPAs to Net Advances (1999-00)

Figures in percentage

Corporation Bank	1.91
Syndicate Bank	**3.17**
Andhra Bank	**3.47**
Oriental Bank of Commerce	**3.61**
Canara Bank	**5.28**
State Bank of Patiala	**6.09**
State Bank of India	**6.41**
Vijaya Bank	**6.62**
Bank of Baroda	**6.95**
Bank of Maharashtra	**6.97**
State Bank of Hyderabad	**7.3**

Top Ten Public Sector banks – NPAs to Net Advances (1999-00)

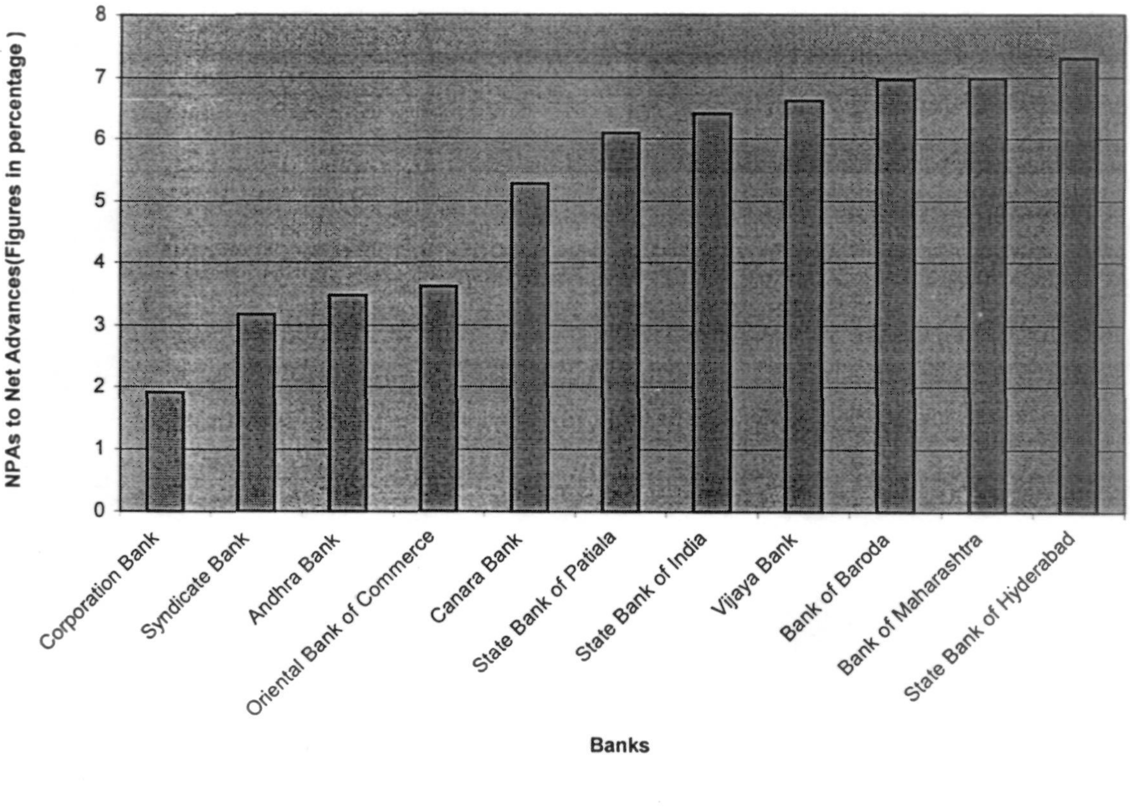


Table 7: Top ten Public sector banks – NPAs to Net Advances (2000-01)

Figures in percentage

Corporation Bank	1.98
Andhra Bank	2.95
Oriental Bank of Commerce	3.59
Syndicate Bank	4.07
Canara Bank	4.84
State Bank of Patiala	4.92
State Bank of Indore	5.91
State Bank of India	6.03
Vijaya Bank	6.22
UCO Bank	6.3
Punjab National Bank	6.69

Table 8: Top ten Public sector banks – NPAs to Net Advances (2001-02)

Figures in percentage

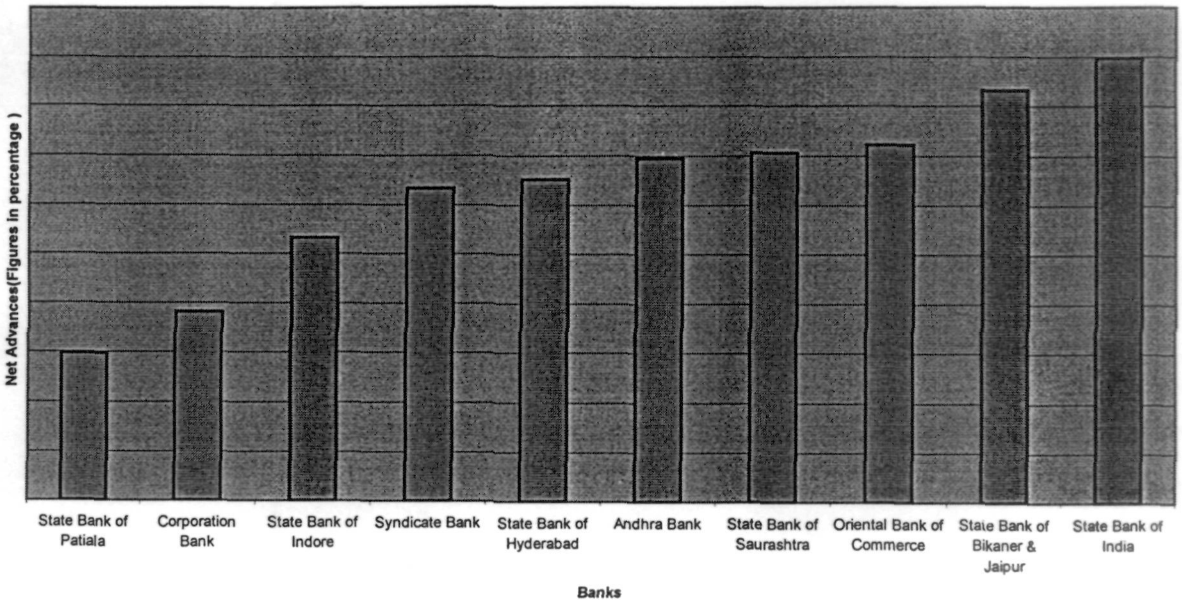
Corporation Bank	1.98
Andhra Bank	2.95
Oriental Bank of Commerce	3.59
Syndicate Bank	4.07
Canara Bank	4.84
State Bank of Patiala	4.92
State Bank of Indore	5.91
State Bank of India	6.03
Vijaya Bank	6.22
UCO Bank	6.3

Table 9: Top ten Public Sector banks – NPAs to Net Advances (2002-03)

Figures in percentage

State Bank of Patiala	1.49
Corporation Bank	1.91
State Bank of Indore	2.66
Syndicate Bank	3.17
State Bank of Hyderabad	3.26
Andhra Bank	3.47
State Bank of Saurashtra	3.53
Oriental Bank of Commerce	3.61
State Bank of Bikaner & Jaipur	4.16
State Bank of India	4.49

Top ten Public Sector banks – NPAs to Net Advances (2002-03)



As per a report compiled by ICRA, the combined net profits of the 27 PSU banks increased by 48 per cent to Rs 12,294 crore in the last fiscal. The net profits had increased 92.5 per cent in 2001-02. Thus, the net profit of PSU banks increased 2.8 times during the last two financial years. Of the total State Bank of India and its associates contributed Rs 4,510 crore or 36.7 per cent of the pie, while the share of 19 nationalised banks was at 73.3 per cent at Rs 7,784 crore.

SBI topped the list posting a net profit of Rs 3,105 crore. SBI was followed by Canara Bank with a net profit of Rs 1,019 crore, Bank of India (Rs 851 crore), Punjab National Bank (Rs 842 crore) and Bank of Baroda (Rs 773 crore), the report compiled by ICRA Information, Grading & Research Service said.

Net NPAs fell drastically from 5.8 to 4.5 per cent. Gross NPAs came down to less than 10 per cent from 11.1 per cent. The PSU banks were able to reduce their Gross NPAs to 9.2 per cent at about Rs 54,134 crore while Net NPAs came down to 4.5 per cent Rs 24,974 crore. Three of the eight SBI and Associate banks had a net NPA exceeding 10 per cent in 1996-97 but the number reduced to NIL in 2002-03.

3.2 ANALYSIS OF NPAs STATISTICS OF RRBS

Although the co-operative and commercial banks had an impressive record in terms of geographical coverage and disbursement of credit, it was observed that the vast majority of the poor were generally deprived of credit and other banking facilities. In order to provide access to low-cost banking facilities to the poor, a new set-up of banks, viz. RRBs, was established in the country to meet exclusively the needs of the weaker sections of the rural population, as institutions which "combine the local feel and the familiarity with rural problems which the cooperatives possess and the degree of business organization, ability to mobilize deposits, access to central money markets and modernized outlook which the commercial banks have".

From a modest beginning with 6 RRBs in 1975, as many as 196 RRBs were operating in 500 districts with a network of 14,313 branches as on 31 March, 2001 excluding satellite branches and extension counters. The branch network comprises 6 metropolitan, 348 urban, 1875 semi-urban and 12,084 rural branches. RRBs have a large branch network in the rural area, which forms nearly 37% of the total rural branch network of all scheduled commercial banks.

RRBs, being an important segment of the Rural Financial Institutions in the country, have carved out a special place for themselves in terms of geographical coverage, clientele outreach, business volume and contributions for development of rural economy. RRBs are focusing their attention on the attainment of sustainable viability, improved customer services, new and innovative loan products and diversified business portfolio. RRBs are at par with the scheduled commercial banks in respect of priority sector lending, investment avenues and credit discipline and transparency. While the performance of many RRBs improved significantly, the performance of some of them remains far from being satisfactory in view of their tardy business growth and lack of operational viability.

RRBs and NPA

Table 11: gross NPAs OF RRBs

(Amount in Rs. Lakhs)

Year	Gross NPAs	Gross Advances	Gross NPAs Ratio %
As on March 31, 2002	306696	1862922	16.46
As on March 31, 2003	320151	2216058	14.45

Source: Annual Accounts of the Banks of respective years for commercial banks And NABARD for RRBs.

Table 12: Top ten Banks: Gross NPA Ratio on 31 March 2002

Gross NPA Ratio	**Bank**
0.06	PITHORAGARH KSHETRIYA GRAMIN BANK
1.49	JAMNAGAR GRAMIN BK
2.38	NETRAVATI GRAMIN BANK
3.23	MARUDHAR KSHETRIYA GRAMIN BANK
3.39	VIDUR GRAMIN BANK
4.02	KAPURTHALA-FEROZPUR KSHETRIYA GRAMIN BANK
4.42	MALWA GRAMIN BANK
4.49	PANDYAN GRAMIN BANK
4.51	SHRI VENKETESHWARA GRAMIN BANK
4.64	MARWAR GRAMIN BANK
4.77	SURENDRANAGAR-BHAVNAGAR GRAMIN BANK

Table 13: Worst ten Banks: Gross NPA Ratio on 31 March 2002

Gross NPA Ratio	Bank
41.33	BALLIA KSHETRIYA GRAMIN BANK
41.72	BALASORE GRAMIN BANK
43.67	BHAGALPUR-BANKA KSHETRIYA GRAMIN BANK
43.74	DURG-RAJNANDGAON GRAMIN BANK
44.33	LANGPI DEHANGI RURAL BANK
49.69	TRIPURA GRAMIN BANK
49.85	MONGHYR KSHETRIYA GRAMIN BANK
50.06	ALLAHABAD KSHETRIYA GRAMIN BANK
51.6	VINDHYAVASINI GRAMIN BANK
69.91	ARUNACHAL PRADESH RURAL BANK

Table 14: Top ten Banks: Gross NPA Ratio on 31 March 2003

Gross NPA Ratio	Bank
0.04	PITHORAGARH KSHETRIYA GRAMIN BANK
1.85	KANPUR KSHETRIYA GRAMIN BANK
2.39	VIDUR GRAMIN BANK
2.71	NETRAVATI GRAMIN BANK
3.14	JAMNAGAR GRAMIN BK
3.16	SHRI VENKETESHWARA GRAMIN BANK
3.26	ADHIYAMAN GRAMIN BANK
3.26	MALWA GRAMIN BANK
3.69	SURENDRANAGAR-BHAVNAGAR GRAMIN BANK
3.95	ALWAR-BHARATPUR ANCHALIK GRAMIN BANK
4.06	PANDYAN GRAMIN BANK

Table 15: Worst ten Banks: Gross NPA Ratio on 31 March 2003

Gross NPA Ratio	Bank
36.97	MONGHYR KSHETRIYA GRAMIN BANK
37.19	BALLIA KSHETRIYA GRAMIN BANK
38.86	SARAN KSHETRIYA GRAMIN BANK
39.05	SANTHAL PARGANAS GRAMIN BANK
39.29	MARATHWWADA GRAMIN BANK
40.34	VINDHYAVASINI GRAMIN BANK
40.37	BHAGALPUR-BANKA KSHETRIYA GRAMIN BANK
41.84	SURAT-BHARUCH GRAMIN BANK
47.57	ALLAHABAD KSHETRIYA GRAMIN BANK
79.02	ARUNACHAL PRADESH RURAL BANK

NPAs of all the RRBs have declined from 23.1 per cent as on 31 March 2001 to 16.45 per cent as on 31 March 2002. CD Ratio increased to at the level of 42% as on 31 March 2002 as against 41 per cent as on 31 March 2001. A viability-based review of RRBs shows that the loss-incurring RRBs are concentrated in 3 States viz Bihar, Madhya Pradesh and Orissa and in four Sponsor Banks viz UCO Bank, SBI, BOI and BOB. Their common characteristics included low productivity, high transaction costs, lower CD ratio, negative margins, low recovery rates and high NPAs.

The recovery performance of RRBs have shown a consistent improvement from around 40% in 1991-92 to 70 % during the year 2001-02. The NPAs of RRBs have also been declining in percentage terms and stood at 16% as on 31 March 2002 as against 43% as on 31 March 1996 when the norms were first made applicable to the RRBs.

In order to reduce the stock of NPAs as also to improve the recovery of sticky advances, One-Time Settlement Scheme for recovery of NPAs have been introduced in RRBs. The scheme was valid up to 31 March 2002 and a sum of Rs. 208 crore have been recovered by RRBs under the scheme.

3.3 IMPACT OF NPAs ON BANKS'

"The efficiency of a bank is not always reflected only by the size of its balance sheet but by the level of return on its assets. NPAs do not generate interest income for the banks, but at the same time banks are required to make provisions for such NPAs from their current profits.

NPAs have a deleterious effect on the return on assets in several ways -

- They erode current profits through provisioning requirements
- They result in reduced interest income
- They require higher provisioning requirements affecting profits and accretion to capital funds and capacity to increase good quality risk assets in future, and
- They limit recycling of funds, set in asset-liability mismatches, etc

There is at times a tendency among some of the banks to understate the level of NPAs in order to reduce the provisioning and boost up bottom lines. It would only postpone the

In the context of crippling effect on a bank's operations in all spheres, asset quality has been placed as one of the most important parameters in the measurement of a bank's performance under the CAMELS supervisory rating system of RBI.

Impact on Profitability

Between 01.04.93 to 31.03.2001Commercial banks incurred a total amount of Rs.31251 Crores towards provisioning NPA. This has brought Net NPA to Rs.32632 Crores or 6.2% of net advances. To this extent the problem is contained, but at what cost? This costly remedy is made at the sacrifice of building healthy reserves for future capital adequacy. The enormous provisioning of NPA together with the holding cost of such non-productive assets over the years has acted as a severe drain on the profitability of the PSBs. In turn PSBs

are seen as poor performers and unable to approach the market for raising additional capital. Equity issues of nationalised banks that have already tapped the market are now quoted at a discount in the secondary market. Other banks hesitate to approach the market to raise new issues. This has alternatively forced PSBs to borrow heavily from the debt market to build Tier II Capital to meet capital adequacy norms putting severe pressure on their profit margins, else they are to seek the bounty of the Central Government for repeated Recapitalisation.

Considering the minimum cost of holding NPAs at 7% p.a. (reckoning average cost of funds at 6% plus 1% service charge) the net NPA of Rs.32632 Crores absorbs a recurring holding cost of Rs.2300 Crores annually. Considering the average provisions made for the last 8 years, which works out to average of Rs.3300 crores from annum, a sizeable portion of the interest income is absorbed in servicing NPA. NPA is not merely non-remunerative. It is also cost absorbing and profit eroding.

In the context of severe competition in the banking industry, the weak banks are at disadvantage for leveraging the rate of interest in the deregulated market and securing remunerative business growth. The options for these banks are lost. "The spread is the bread for the banks". This is the margin between the cost of resources employed and the return therefrom. In other words it is gap between the return on funds deployed(Interest earned on credit and investments) and cost of funds employed(Interest paid on deposits). When the interest rates were directed by RBI, as heretofore, there was no option for banks. But today in the deregulated market the banks decide their lending rates and borrowing rates. In the competitive money and capital Markets, inability to offer competitive market rates adds to the disadvantage of marketing and building new business.

In the face of the deregulated banking industry, an ideal competitive working is reached, when the banks are able to earn adequate amount of non-interest income to cover their entire operating expenses i.e. a positive burden. In that event the spread factor i.e. the difference between the gross interest income and interest cost will constitute its operating profits. Theoretically even if the bank keeps 0% spread, it will still break even in terms of operating profit and not return an operating loss. The net profit is the amount of the operating profit minus the amount of provisions to be made including for taxation. On account of the burden of heavy NPA, many nationalised banks have little option and they are unable to lower lending rates competitively, as a wider spread is necessitated to cover cost of NPA in the face of lower income from off balance sheet business yielding non-interest income.The following working results of Corporation bank an identified well managed nationalised banks for the last two years and for the first nine months of the current financial year, will be revealing to prove this statement-

Table 16. (part-1) ....Performance of Corporation Bank ....(Amount in Crores) Performance indicator	Year ended Mar. 2000	Year ended Mar. 2001	9 months Apr.Decr. 2001
Earnings - Non-interest	270.81	292.09	285.85
Operating expenses	303.99	341.36	280.52
Difference	- 33.18	- 49.27	5.33

Non-interest income fully absorbs the operating expenses of this bank in the current financial year for the first 9 months. In the last two financial years, though such income has substantially covered the operating expenses (between 80 to 90%) there is still a deficit left. Now what are the interest earnings and expenses of Corporation Bank during this period?

Table -17 (part-1) Corporation Bank -Interest Earnings and Expense..................... (Amount in Crores) Performance indicator	Year ended Mar. 2000	Year ended Mar. 2001	9 months Apr.Decr .2001
Earnings – Iinterest Income	1604.39	1804.54	1458.33
Exp.-Interest expenses	1146.09	1223.21	981.45
Interest spread	458.30	581.33	476.88
Operating Profit	425.12	482.21	532.06
Provisions	192.68	270.22	219.48
Net Profit	232.44	261.84	262.73

The strength of Corporation Bank is identified by the following positive features:

It is worthwhile to compare the aggregate figures of the 19 Nationalised banks for the year ended March 2001, as published by RBI in its Report on trends and progress of banking in India.

Table 18- Nationalised banks operational statistics.......... (Amount in Crores) Performance indicator	Year ended Mar. 2000	Year ended Mar. 2001
Earnings – Non-interest	6662.42	7159.41
Operating expenses	14251.87	17283.55
Difference	- 7589.45	- 10124.14
Earnings – interest income	50234.01	56967.11
Exp.-Interest expenses	35477.41	38789.64
Interest spread	14756.60	18177.47
Intt. On Recap bonds	1797.88	1795.48
Operating Profit	5405.27	6257.85
Provisions	4766.15	5958.24
Net Profit	639.12	299.61

Interest on Recapitalisation Bonds is a income earned from the Government, who had issued the Recapitalisation Bonds to the weak banks to sustain their capital adequacy under a bail out package. The statistics above show the other weaknesses of the nationalised banks in addition to the heavy burden they have to bear for servicing NPA by way of provisioning and holding cost as under:-

Their operating expenses are higher due to surplus manpower employed. Wage costs to total assets is much higher to PSBs compared to new private banks or foreign banks.

Their earnings from sources other than interest income are meagre. This is due to failure to develop off balance sheet business through innovative banking products.

How NPA Affects the Liquidity of the Nationalised Banks?

Though nationalised banks (except Indian Bank) are able to meet norms of Capital Adequacy, as per RBI guidelines, the fact that their net NPA in the average is as much as

7% is a potential threat for them. RBI has indicated the ideal position as Zero percent Net NPA. Even granting 3% net NPA within limits of tolerance the nationalised banks are holding an uncomfortable burden at 7.1% as at March 2001. They have not been able to build additional capital needed for business expansion through internal generations or by tapping the equity market, but have resorted to II-Tier capital in the debt market or looking to recapitalistion by Government of India.

How NPA Affects the Outlook of Bankers towards Credit Delivery

The fear of NPA permeates the psychology of bank managers in the PSBs in entertaining new projects for credit expansion. In the world of banking the concepts of business and risks are inseparable. Business is an exercise of balancing between risk and reward. Accept justifiable risks and implement de-risking steps. Without accepting risk, there can be no reward. The psychology of the banks today is to insulate themselves with zero percent risk and turn lukewarm to fresh credit. This has affected adversely credit growth compared to growth of deposits, resulting a low C/D Ratio around 50 to 54% for the industry.The fear psychosis also leads to excessive security-consciousness in the approach towards lending to the small and medium sized credit customers. There is insistence on provision of collateral security, sometimes up to 200% value of the advance, and consequently due to a feeling of assumed protection on account of holding adequate security (albeit over-confidence), a tendency towards laxity in the standards of credit appraisal comes to the fore. It is well known that the existence of collateral security at best may convert the credit extended to productive sectors into an investment against real estate, but will not prevent the account turning into NPA. Further blocked assets and real estate represent the most illiquid security and NPA in such advances has the tendency to persist for a long duration.

Nationalised banks have reached a dead-end of the tunnel and their future prosperity depends on an urgent solution of this hovering threat.

Chapter 5

- ✓ Reasons of Mounting NPAs

4.0 REASONS FOR MOUNTING NPAs

Banking is not 100% safe business. The entire money lent by a way of advance may not come back, as a certain percent of the total advance is bound to be lost or become irrecoverable. It may also be pointed out that the government has not been able to implement the recommendations the of the various committees. With regard to the establishment of the **Asset Reconstruction fund (AFR)**, bank need to resort to other measures to reduce their NPAs. These are recovery effort, rephrasing of loans, negotiated settlement, rehabilitation of sick viable units, mergers or acquisitions of units, legal actions, etc. but banks have always adopted a lukewarm attitude in adopting any of these measures in the absence of any long range planning in banks. In fact the Board of Directors of many banks just pays scant regard to recovery of the dues with seriousness and the amount of dedication has needed for such efforts. It is always more convenient to adopt the line of least resistance. The result is that nobody bothers as to why banks should be put to loss and no one wants to displease the defaulters who are either vote banks for ruling party or they are influential people with political clout, or perhaps because banks officials are hand-in-glove with defaulters.

BAD AND doubtful debts of banks, called non-performing assets or NPAs in banking jargon, have been attracting wide attention for varied reasons. Some of the reasons for the burgeoning NPAs are: Bank officers do not know how to lend and are also corrupt.

A major portion of bad debts arose out of lending to the priority sector, at the dictates of politicians and bureaucrats. If only banks had monitored their loans effectively, the bad debt problem could have been contained, if not eliminated.

The top management of the banks were forced by politicians and bureaucrats to throw good money after bad in the case of unscrupulous borrowers. Many big borrowers defaulted only due to the recession in the economy. The absence of proper bankruptcy laws and the dilatory legal procedures in enforcing security rights are the root cause of bad debts in banks.

These and similar views are freely expressed by knowledgeable people in the field. All the above statements have some elements of truth. It is like six blind persons looking at an elephant and describing its physical characteristics. Unless the problem is identified properly, no remedial action is feasible.

In a layman's perception, NPA formation in a bank is paradoxical. Unlike moneylenders who on several occasions lend money without any collateral, the advances made by the banks are generally backed by some kind of collateral, which can be liquidated in case of default. This collateral is in fact insisted on while making an advance to guard against the possibility of default. But the problem arises in several cases of default when some of these collaterals could not be acquired or liquidated by the bank to realise the loss involved. This inability was primarily due to institutional constraints, such as inappropriate legal framework, political interference or the general non-compliance attitude of the borrowing community. In addition to that, the existence of inadequately formed asset market might have aggravated the problem further. High transaction costs of operating in such a market also may be another reason.

Even if we accept that NPA is a fact of life, so far as banking practices are concerned, then ideally there should be no reason why one should be worried about it. A bank can obtain the desired rate of return through properly adjusting the rate of interest on different categories of loans/advances in accordance with their risk profile. If the sample size is large enough for different categories of advances, which is in fact true for most of the Indian PSBs, the realised return, and desired return on the total asset of the bank would coincide. The loss due to NPA would exactly be compensated by higher interest earning in specific risk categories. In other words, high incidence of NPA need not necessarily affect the profitability of the bank. In fact, both can go together. This is because high profits can be earned only at the cost of facing high risk i.e. generating high NPA.

There is no problem with a moderate NPA as it can be taken care of by differential rates of interest on advances made to different sectors. However,

there is a limit to which the rate of interest can be increased in order to reflect the high profile of an asset category. If NPA becomes very high, it will be difficult to deal with its aftermath by means of an increase in rate of interest. A rise in the rate of interest may go against the central bank's dictum. It may also lead to adverse selection a la Akerlof (1970). If the increment in the rate of interest were very high, the problem would be

aggravated by further increase in default. This occurs through two routes. Firstly, at a high rate of interest, a section among borrowers borrows with an intention to default. Secondly, an increase in the probability of default would take place either because individuals take more risk when the interest rate is higher. One may add that if the demand for loans is inelastic, raising the rate of interest may not reduce the demand for credit. It may create a category of genuine defaulters whose margin is squeezed. This poses a limit to the use of the tool of raising the interest rate to overcome NPA problems.
In case of large NPA accumulation by a bank, it may also react by decreasing its exposure to the particular sector generating high NPA and changing its composition of advances. However, this is also not without problems. With change in the composition of advances and increase in advances to non-risky sectors, rate of interest offered to these sectors will fall. This is currently happening to Indian banks which when faced with NPAs originating from industries affected by recession are increasing their investment in government securities on the one hand and wooing the household sector with lower interest rate on personal loans on the other.

However, apart from ceiling on interest rate or statutory restrictions on interest rates for some categories of loans irrespective of their risk profile, there may exist genuine problems of estimation of risks. Risks may not be time independent. They vary with the changes in overall business conditions. They may increase with economic slowdown and decrease with economic upturn. In addition to this there may also exist the problem of moral hazard or intentional default, principal agency problems where managers satisfy their own interest without considerations to the depositors/shareholders, political intervention and contagious effects in case of non-recovery, and all this may aggravate the problem of NPA. In fact, many of these factors proved very critical for the Indian PSBs, raising the NPA to an alarming level. This indicates that the role of evaluation and monitoring by the banks and transparency in banking operations assumes primary importance.

For analytical simplicity, the occurrence of default, in the Indian context, may be split into two components: random and the non-random components. The random component of default is assumed to be stochastic in nature. The different economic or commercial activities involve different levels of risks that are faced by borrowers with varied ability to sustain. Consequently, these risks are translated into NPAs through default. The relevant parameters can be estimated with a high degree of confidence when the number of borrowers in different categories of advances is reasonably high.

First, the facts. The total NPA of all scheduled commercial banks in India had swollen from Rs. 47,300 crores to Rs. 70,904 crores during the five years from March 1997 to March 2002, as per the Reserve Bank's annual reports on trends and progress of banks in India.

Against these, banks had provided for Rs. 35,358 crores or roughly half the total by 2002. Still, the net NPA was as high as Rs. 35,546 crores and represented 5.5 per cent of the total advances; this is high compared to around 2 per cent for banks in advanced countries.

One extenuating feature for Indian banks is that the NPA amounted to a mere 2.3 per cent of total assets. This is because advances comprise less than 50 per cent of total assets, with the banks having invested heavily in government securities in India. With banks required to keep their own capital and reserves at

a minimum of 9 per cent of the advances portfolio, the NPA level is not such as to cause concern about the health of the banking system.

Let us now examine the reasons for the higher levels of NPA in Indian banks

There are some important reasons for the mounting NPAs. These are as follows:

1. The Legal Environment:

Foundations of corporate governance mechanisms are the laws that provide protection to suppliers of finance and legal institution that enforce these laws, the former determine the power of the suppliers of finance and latter the speed and efficiency with which they can be used. A RBI report qoutes a paper brought out by Fitch IBCA- an international agency which places the blame for high NPAs on legal system. The paper states that " The Indian legal system is sympathetic towards the borrowers and work against the bank interest. The result of survey on NPAS in Indian bakns showed that 27 PSBs and 6 Private sector banks filed siuts for the recovery of 46.38% of their NPAs in 1999, but were able to recover only 4.32% and the significant portion of suites have been pending for more than a decade. The legal system for recovery of is longer when cases are reffered to the Board of Industrial and Financial Reconstruction (BIFR). This is because special provision of the sick Industrial Companies Act (SICA), 1985 bar banks from taking actions in such caes. It has been seen that the foreign banks have lower NPAs. But in india their NPAs are higher than the percentage in their home countries or the ones in low risk countries. They also blame the judicial system in india for it.

It may also be mentioned that there is no social stigma attached to the defaulters, especially wilful defaulters. Further, it is becoming increasingly futile to keep the litigation alive for long, as it is only a drain on resources. These legal procedures are highly time consuming as the matters get invariably delayed with law courts granting adjournments one after another for any small reason. More money is spent than what is hoped to be recovered by pursuing these cases in the courts of law. Despite most of the loans being backed by security, banks are unable to enforce their claims on the collateral, when loans turn non-performing, and therefore loan recoveries remain insignificant. Un-sustainability of litigation in cases where borrowers are neither paying up nor likely to do so makes provisioning against these NPAs a losing proposition. The bank may feel that a write-off against such loans would help clean up the balance sheet and induce greater transparency. Thus there may be a tendency to write off a small amount of advances in the face of prohibitive legal and administrative cost and inordinate delay in final settlement.

2. Public Ownership of Banks and Market Discipline:

Implicit guarantees provided by the Government to the banks for their ending to the corporate sector led to inadequate credit appraisal and risk management by banks. This created a financial sector vunrelable to external shocks. The public and the de facto the contro rests with the bureaucrates contro state firm's. these bureaucrates have control rights but no right to the cash flow generated by the firm, resulting in litle concern for performance. The lack of managerial incentives to control NPAs in public sector banks owing to state ownership also createds the danger that banks may not take use of investor friendly laws and institutions.

The Indian commercial banks suffer from this syndrome. A market mechanism to deal this problem is to all the public sector banks to approach private investor for equity. Already concerns about high NPAs level the stock market in the recent past. The share prices of major banks have been fallen significantly.

a) Lack of organisational learning in the bank - repeated lending to same person or group of persons with similar dubious characteristics

Organisational learning on the part of the bank is very important in controlling the growth of NPA. It is obvious that with the experience of repeated lending over a period of time to varieties of borrowers, a bank can identify a particular type of borrower who is more likely to default. But in practice it fails to learn from the past. Due to several constraints, whether internal or external, like political interference, it cannot bar these potential defaulters. For instance, loans have been extended to

industries in the negative list circulated by IDBI, department of industries and RBI.

existing accounts which have gone irregular, i.e. ever-greening of accounts .

a party which is irregular on existing accounts in a different branch of the same bank.

several projects with promoters or directors with doubtful integrity.

b) Lack of vision of bank in sanctioning, reviewing and enhancing credit limits

While examining long term viability, both foresight as well as proper scrutiny is lacking on the part of the bank. Inefficient decisions have resulted in many newly born projects turning sick or closing down. There are instances in which instalments and interest have become due before the commencement of commercial production. Such accounts are considered as NPA, which reflects improper scrutiny and failure in considering moratorium period on a realistic basis.

3. Political Interference:

In Indian banking system has been extensively misused for political reasons in the past. Bed debts are a legacy of this misuse. The NPAs in priority sector advances of PSBs are 46-49% of their overall NPAs while priority sector advances form only 3-32% of their total advances. In addition to large-scale loan

write-offs ordered by politicians promote a culture on indiscipline and lawlessness among borrowers. This adds to the problems of banks already functioning in a legal environment. Political leaders/organisations wield enormous power over the banks in granting loans to particular borrowers. It pays the political leaders to encourage default by the borrowers, in the absence of an efficient legal system. For instance, rural panchayats are responsible for recommending loans, but once the loan is disbursed, these rural political bodies take no initiative to ensure that the loan is serviced and repaid. There are many instances where big companies received a large volume of loans under political influence and were able to escape punishment
after default. Examples include UB Engineering promoted by Vijay Mallya, an MP in the Rajya Sabha and Mukand Steel promoted by Viren Shah, current governor of West Bengal.

4. Competition, Liberalization and Gambling:

Abolition of license raj and hotting up of competition in the liberalizing Indian economy has changed the complexion of the some of the earlier sought after borrowers, some of the renowned industrial houses are on the brink of extinction. The commercial banks have now been providing for bad loans of the advances portfolio handled by them in the past as the proud bankers of the then reputed companies. The fast changing technology has thrown out of the market some of the companies which could not manage to keep themselves in tune with the requirement of rapid technological advances and those companies have to close down their shutters. Thus the transition period of Indian Economy which has been opening up after liberalization will contribute to the new NPAs. Now every bank has the option of investing in a "prudent asset" that yield relatively little or in a inefficient "gambling asset" that yield high return if gamble pays of and impose cost on depositors and deposit ensure if it fail.

5. Inadequate Management Risk Practices:

The level of NPAs varies greatly among banks. It is obvious that some banks are better able to manage credit risk in the fact of existing constraints than others. This under scores the importance of internal, risk management system in the bank. Risk management should be proactive rather than reactive. The appraisal criteria of the commercial; banks may not be sophisticated, however in case of foreign banks, they are only selective in granting credit but are concise and focus on appraisal system and faster in delivery of credit. Appraisal management is not a competent enough in commercial banks to identify the viable and non-viable projects.

6. Lack of Prudential Regulation:

Risk management practices can be effective only when financial statements presents accurate picture of level; of the risk. The income recognition norms being followed by bank prior to 1992-93 involved recognition of income earned on bad debts in their book on an accrual basis. Thus their financial statement does not reflect the level of bad debts and presented and misleading rosy picture of their health. This allows the situation to degenerate considerably before it was detected.

Sometime advances would run bad due to wrong policies or procedure or due to absence of prudential norms. Credit of hundred commendable decisions is washed away by one incorrect small judgment.

7. Diversion of Funds by Borrowers:

Because of increasing competition and changing economic policy and environment borrowers are diversifying their business. Diversion of funds is also for modernization, setting up new projects, helping or promoting sister concerns and if all these techniques failed it will generate the NPAs.

8. Inefficient Monitoring over the Use of Funds:

After granting of loans most of the time bank official is not bother about its use by the borrowers. They don't take interest to know that it is use in right direction or not. It depends on the will of the manager to the monitor it or not and borrowers are diversifying their business in hope of better and more return.

9. Lack of Effective Follow Up Due Larger Number of Accounts:

Because of large number of lending cases it is not possible for the banks limited staff to follow each and every borrower that he is using the fund properly or not.

10. The high share of lending to the priority sector, consisting of primarily agriculture and SSI, contributed to NPAs in a big way:

The agricultural sector achieved a moderate growth (3.12 percent per annum) in the 1980s which was slightly reduced in the 1990s (2.98 percent per annum). Similarly, the SSI sector's performance was also impressive. It was as high as 11.63 percent in the eighties, which declined to 8.59 percent in 1990-2001. NPAs in these sectors cannot be attributed to their poor performance.

However, in agriculture, price crash of commercial crops after harvest is a common phenomenon, which leads to loan defaults by the farmers. Sometimes, failures of the high valued crops, like cotton due to pests attack or other reasons, may lead to default by farmers as recently noted in many states of India.

However, the explanation of NPAs was not in terms of their performance, but in terms of the indiscriminate choice of the borrowers that contributed to the high incidence of default. There is some element of truth in it as this sector's share of NPAs is more than that of loans as in 1993. Nevertheless, over time its share in loan declined but the decline in the share of NPAs was faster than the share of the loans (Mukherjee, 2003). The growth rate of NPAs of the priority sector was 3.9 percent which was much lower than that of the non-priority sector (6.4 percent) during the period 1993 - 2001. The relative improvement of the priority sector's NPAs in the later part of the 1990s may be attributed to the more cautious approaches and policies of the banks and their exertion of choice in selecting borrowers helped to motivate the borrowers, who are generally small, to repay the loans in due time. Using the same logic one may say that in the non-priority sector it is neither possible to deny loans to a large number of big borrowers nor to motivate them to repay. In consequence NPAs due to the non-priority sector are growing disproportionately.

The banks NPAs in priority sector have increased in recent years. Government is treating with them leniently because of political interest. And to oblige government gives them relief and concessions to unproductive. Priority sector projects. These are causing increase in NPAs.

11. Absence of Adequate Security:

Security against the loan is not adequate to meet the demand of lender in case of default. In various cases immovable property as security kept by borrower is not easily liquidated in the market and the borrower take the stay order from the court on its sale. So the bad debt is not recoverable and this situation is mounting NPAs.

12. Strained Labor Relations in Lending Firm:

In various cases it has been seen that strained labor relation in the lending firm stopped the production work and it affects the economic condition of the company. If the dispute is not resolved immediately and production work restored it will cause increase in unused fund hence increase in NPAs.

Rising NPAs phenomenon is to be attributed to the government is so far as Board of Directors is not professionalism. Banking experts do not get nominated to the board of directors nor in their any autonomy granted to the board. The generalist representative of the government rules the roots. The question, who is responsible for sanctioning of loans that have become NPAs, is nobody's

concern. Fixing responsibility for bad decisions is totally absent instead very liberal write-off of bad debts is approved without betting an eyelid in order to reduce NPAs.

13. Wrong lending decisions

One of the primary reasons for NPA could be that the lending decision was, ab initio, incorrect. Seasoned bankers would scoff at this as a preposterous statement, but the reality has to be faced.

A major portion of bank lending is to industries and trade; this segment accounted for over 53 per cent of gross bank credit, excluding loans to food procurement agencies of governments, as at the end of March 2002, vide RBI data. In lending to these borrowers, bankers have to relearn a lot.

Till the early 1960s, bankers lent only to traditional companies owned by "respected" business groups and relied primarily on the credentials of the group. The emergence of small scale industries and the gradual opening up of the economy changed the scenario with many new entrepreneurs on the scene and bankers had to learn newer ways of assessment and appraisal.

In 1974, an expert committee under the chairmanship of Prakash Tandon rewrote the policies and procedures of lending to industries by banks. These were implicitly followed by all banks under the directions of RBI. While the 'norms' prescribed by the Tandon Committee were appropriate for the conditions in 1970s, banks were following them even after 20 years.

In the late 1990s the RBI freed banks from the shackles of the norms, but banks are yet to get out of their reliance on norms and arithmetical formulae and, instead of understanding and interpreting the numbers judiciously, they

converted a tool into a talisman. Appraisal of credit needs of industrial units and business concerns cannot be put into a straitjacket and banks have to relearn the tricks of the trade. At present, either they deny needed credit to small and medium enterprises because of the norms or go overboard in relation to their bigger customers who enjoy "corporate loans" at ridiculously low interest rates at 5 to 6 per cent p.a. In their obsession with financial data, bank officers do not seem to probe vital aspects such as the need for and the purpose for which credit is needed.

14. Incomplete contract

Contracts are inherently incomplete as it is difficult to specify all the modalities and the terms and conditions prior to signing of a contract. This is seen to be all the more true in the case of financial transactions in the PSBs where many disputes emerged regarding the magnitude of the interest amount dues. For instance, changes in the banking practice of applying and fixing of interest from quarterly to monthly caused confusion regarding the exact annual interest rates and thereby interest bills. Already a large number of litigations involving a sizable amount of bank money is pending in the court, for which neither interest nor the principal is forthcoming.[vi]

15. Low level of expertise

Another factor that can contribute to the low level of expertise in many big public sector banks is the constant rotation of duties among officers and the apparent lack of training in lending principles for the loan officers.

Being dictated to by the bureaucrats in the Government, public sector banks are asked to frown upon specialisation of officers in any particular branch of banking; this also makes it hard for developing a fully trained cadre of lending officers.

If the public sector has to compete in the fierce financial markets, they have to create and nurture a good cadre of officers in various disciplines. Corruption, as a cause for NPA, is, in the author's opinion, not a serious one. The number of officers who are not scrupulously honest will not be large in banks; in any case, unlike government departments, banks are not monopolies in rendering service and customers will not tolerate undue levels of corruption.

Many among the intelligentsia, who belong to the service class, still believe that the priority sector, comprising the small trader, industrialist and the farmer, is responsible for the NPA problem.

This arises from the notion that such small people are either more dishonest than the larger borrowers or are more prone to business failure. While a small business/industry/farmer is more susceptible to recessionary conditions in the economy, they are certainly not more dishonest than the bigger ones.

16. High incidence of NPAs are a result of slowdown of the economy, particularly industrial recession

The macro factors that are popularly adduced to explain high incidence of NPAs include slow down of the economy, particularly in the industrial sector, liberalisation, the South East Asian Crisis, effect of globalisation on domestic industries and cyclical factors. It is difficult to isolate the impact of liberalization or South East Asian crisis on NPAs, but one can relate the latter to economic slow down. During 1993 and 2001, gross NPAs increased at a rate of 5.01 percent per annum. The growth rate of GDP at factor cost in India was reasonably high (5.52 per cent per annum) during the 1980s which accelerated in the 1990s to reach 6.12 percent per annum. The growth performance of the industry sector was even better in the 1980s and 1990s - although it marginally declined from 7.65 percent per annum to 6.59 percent per annum between the two decades. It seems that the stagnation/recession hypothesis of NPAs is not corroborated by the factual position. However it may happen that some specific industries stagnated and contributed to high NPAs which is discussed below.

17. Stagnation in specific industries with large share of loans contributed to NPAs

As on March 31, 2001, industry shared 43.58 percent of the outstanding credit of the PSBs. Textiles shared 6.10 percent of which cotton textiles shared 2.37 percent. Basic metal and metal products shared 5.84 percent, within this group iron and steel shared 4.22 percent. Personal loans including housing shared a very high proportion of the total outstanding credit (11.73 percent). According to the estimates of Uchikawa (2001), the growth performance of the textiles industries was rather slow in the 1980s (4.8 percent) which turned to be negative in the 1990s (-1.1 percent). Wood industries witnessed a negative growth in the 1980s (-2.1 percent) which however made some improvement in the 1990s. The industries that did not perform so well over these decades, include leather, beverage and metals industries. Dasgupta undertook a study on financial risk, measured in terms of Altman's Zeta Score, on several industry groups for the years from 1993-94 to 1999-2000. It was observed that textiles, paper, pig iron and sponge iron, steel and castings had high risks throughout the period. Cement, sharing the major part of the non-metallic mineral products, started becoming riskier after 1996-97. Leather products were able to overcome their financial risks and metal products, which were earlier not risky, have become so since 1997-98.

It is therefore evident that selected groups of industries became a major source of NPA accumulation. Steel being so important in this regard, one needs to mention that with the initiation of liberalisation and globalisation and state emphasis on infrastructure building, this industry made massive investment for capacity building. However, for various reasons, it could neither raise exports nor face adequate growth of domestic demand. The unfulfilled expectations raised by liberalisation, contributed towards NPA formation.

18. NPAs are generated as a result of lending to more risky ventures in search of higher profits

One may argue that the banks attempt to earn a high rate of profit by taking risky lending with high interest rates and the high NPA is a necessary outcome. Under such circumstances it is expected that both the NPAs and interest earnings would increase or move together. In order to test this association a simple correlation exercise has been undertaken between gross NPAs to advances ratios and gross interest earnings to advances ratios across PSBs for the years from 1995 to 2001

Apart from the above reasons, there are a number of typical reasons leading to emergence of the NPA problem in the case of Indian PSBs. Some of these include malfunctioning of the institutional environment, captured by its economic, political, legal, social manifestations. The other reasons include use of the bank as an instrument of public policy, incompatibility of bank's interest with certain policy instruments as well as the change in the economic regime. It is also argued that new laws on environment and social security not envisagd at the time of appraisal have also contributed to accumulation of NPA.

19. Use of bank as an instrument of public policy

A number of examples may be cit~~ed in order~~ to show that the use of PSBs as an instrument of public policy has helped accumulation of NPAs. Lending under populist schemes like loan melas, directed lending to certain sectors like mini-steel, mini-paper, mini-cement units, sugar and cotton spinning co-operatives are examples.

20. Use of certain policy instruments cutting across interest of banks

Indecision on exiting out of bad loans through OTS due to fear of investigating agencies like CBI, CVC-have all contributed to worsening the NPA situation of the banks. The banks are owned by the government, which brings them under the purview of CVC, and business decisions are given a go by for adhering to procedures. The private and foreign banks are outside ~~the~~ purview of the CVC, which makes them recover and write off at a faster pace. BIFR is an escape route easily available to a wilful defaulter. Once the case is registered with BIFR, the bank's option to proceed legally is closed. For quite a few corporate houses, reaching to BIFR has become the most convenient route to avoid bank litigation. Over the years the process of revival of sick industries has led to a situation in which the corporate houses do not mind blackmailing the lenders with the threat of taking refuge under the Sick Industrial Companies (Special Provisions) Act. The BIFR experience shows how it has become a safe haven for companies that want to deter a feasible solution such as closure and prefer to be parasites on public money. There is a proposal to repeal Sick Industrial Companies Act that will prevent defaulting companies from taking refuge in BIFR.

21. Intentional misuse of settlement policy of RBI

RBI has initiated a policy of settlement of loans with the borrowers, where an element of concession is granted to the defaulters. This has created a moral hazard problem where even the smaller and less influential borrowers are refusing to pay off their loan and increasing a developing a tendency to misuse of settlement policy of RBI.

In all forums of interactions the global multilateral institutions and rating agencies had with RBI and the Government, directed lending concept gets quoted as an important attribute and a contributory factor for the build up of NPAs in banks in India. It is a different matter that RBI and the Government are accused of soft attitude towards banks which do not fulfill the prescribed targets for priority sector lending, particularly agriculture and small scale sector. To put matters on a proper perspective, I thought I should share some information regarding the contribution by various segments of borrowers to the NPA stock of public sector banks. The picture in the following table as on March 31, 2001, I am sure, is self-revealing.

Table 19. NPAs in different sector

Borrowing segment-wise distribution of gross NPAs	Gross NPAs as on March 31, 2001	
	Amount (Rs. crores)	Percentage to total NPAs
Public sector units	1334.05	2.44
Large Industries	11498.10	20.99
Medium industries	8658.69	15.81
Other non priority sectors	9516.62	17.37
Agriculture	7311.40	13.35
Small scale industries	10284.97	18.78
Other priority sectors	6169.33	11.26
Total	54773.16	100.00

I do understand that recovery of NPAs under priority sector advances particularly to agriculture and small-scale industries is sometimes hampered by externalities. Further, such NPAs are also spread over a large number of accounts and for small amounts.

However, one fails to understand the reluctance of large borrowers to honour their repayment obligations. In many cases, failure of banks to take effective action against some of the defaulting large corporate borrowers was also noticed. This is a factor which prompted the Hon'ble Finance Minister in his recent meeting with CMDs of public sector banks to set a time frame for filing suits against such borrowers to facilitate public disclosure of defaults by big borrowers in the banking system.

Lack of effective co-ordination between banks and financial institutions in respect of large value projects does contribute to the emergence of NPAs even at the implementation stage. RBI had, in February 2000,drawn up certain ground rules in this regard in consultation with banks, financial institutions and IBA and circulated the same among banks and financial institutions for implementation.

Susceptibility of the sanctioning authorities to external pressure, failings of the CEOs and the ineffectiveness of the Board to check his ways also contributed in no small measure to the unusual build up of NPAs in some of the banks.

One of the most prominent causes for NPAs, as often observed by RBI Inspectors, is the slackness on the part of the credit management staff in their follow up to detect and prevent diversion of funds in the post-disbursement stage.

The controversy as to who should be held responsible for diversion of funds – banks or borrowers – may not get settled and is not that material for recovery of NPAs. From the RBI side, I would like to stress that borrowers should, in the interest of the viability of the banking system on which they are dependent, resist all temptations to divert bank funds for uses other than for which they are sanctioned. Banks too on their part should be vigilant to detect and prevent diversion of funds, as any failure in this front is a potential source of NPAs.

Chapter 6

- ✓ Measures initiated by RBI and Government
- ✓ A critical evaluation of the Policy measures to control NPAs
- ✓ Problems with these policies

5.1 Measures initiated by Reserve Bank and Government of India for reduction of NPAs

An analysis of NPAs in the Indian banking system as on March 31, 2001 done internally in RBI had been put up to the Board for Financial Supervision (BFS) in its 79th meeting held on December 27, 2001. In this connection, the BFS directed to conduct a study on slippage of NPA accounts from sub-standard to doubtful category and to arrive at recommendations to prevent such slippage.

As directed by the BFS, a study was conducted by an in-house group in the Bank by scanning relevant information/data obtained from a select group of banks as also by holding discussions with bank officials, who manage NPAs at the policy level as well as those who look after actual recovery, rehabilitation/revival, restructuring of accounts at the implementing level. The group, on the basis of the study, had suggested a framework of recommendations for preventing slippage of NPAs relevant at the banks' level. The draft of these recommendations was circulated amongst the banks for their comments and feedback. While most of the banks concurred with the recommendations, some additional suggestions received from a number of respondents were analysed, and have been factored into the final recommendations.

Compromise settlement schemes

The RBI / Government of India have been constantly goading the banks to take steps for arresting the incidence of fresh NPAs and have also been creating legal and regulatory environment to facilitate the recovery of existing NPAs of banks. More significant of them, I would like to recapitulate at this stage.

The broad framework for compromise or negotiated settlement of NPAs advised by RBI in July 1995 continues to be in place. Banks are free to design and implement their own policies for recovery and write-off incorporating compromise and negotiated settlements with the approval of their Boards, particularly for old and unresolved cases falling under the NPA category. The policy framework suggested by RBI provides for setting up of an independent Settlement Advisory Committees headed by a retired Judge of the High Court to scrutinise and recommend compromise proposals

Specific guidelines were issued in May 1999 to public sector banks for one time non discretionary and non discriminatory settlement of NPAs of small sector. The scheme was operative upto September 30, 2000. [Public sector banks recovered Rs. 668 crore through compromise settlement under this scheme.].

Guidelines were modified in July 2000 for recovery of the stock of NPAs of Rs. 5 crore and less as on 31 March 1997. [The above guidelines which were valid upto June 30, 2001 helped the public sector banks to recover Rs. 2600 crore by September 2001]

An OTS Scheme covering advances of Rs.25000 and below continues to be in operation and guidelines in pursuance to the budget announcement of the Hon'ble Finance Minister providing for OTS for advances up to Rs.50,000 in respect of NPAs of small/marginal farmers are being drawn up.

Measures for faster legal process

Lok Adalats

Lok Adalat institutions help banks to settle disputes involving accounts in "doubtful" and "loss" category, with outstanding balance of Rs.5 lakh for compromise settlement under Lok Adalats. Debt Recovery Tribunals have now been empowered to organize Lok Adalats to decide on cases of NPAs of Rs.10 lakhs and above. The public sector banks had recovered Rs.40.38 crore as on September 30, 2001, through the forum of Lok Adalat. The progress through this channel is expected to pick up in the coming years particularly looking at the recent initiatives taken by some of the public sector banks and DRTs in Mumbai.

Debt Recovery Tribunals

The Recovery of Debts due to Banks and Financial Institutions (amendment) Act, passed in March 2000 has helped in strengthening the functioning of DRTs. Provisions for placement of more than one Recovery Officer, power to attach defendant's property/assets before judgement, penal provisions for disobedience of Tribunal's order or for breach of any terms of the order and appointment of receiver with powers of realization, management, protection and preservation of property are expected to provide necessary teeth to the DRTs and speed up the recovery of NPAs in the times to come.

Looking at the huge task on hand with as many as 33049 cases involving Rs.42988.84 crore pending before them as on September 30, 2001, I would like the banks to institute appropriate documentation system and render all possible assistance to the DRTs for speeding up decisions and recovery of some of the well collateralised NPAs involving large amounts. I may add that familiarisation programmes have been offered in NIBM at periodical intervals to the presiding officers of DRTs in understanding the complexities of documentation and operational features and other legalities applicable of Indian banking system. RBI on its part has suggested to the Government to consider enactment of appropriate penal provisions against obstruction by borrowers in possession of attached properties by DRT receivers, and notify borrowers who default to honour the decrees passed against them.

Circulation of information on defaulters

The RBI has put in place a system for periodical circulation of details of wilful defaults of borrowers of banks and financial institutions. This serves as a caution list while considering requests for new or additional credit limits from defaulting borrowing units and also from the directors /proprietors / partners of these entities. RBI also publishes a list of borrowers (with outstandings aggregating Rs. 1 crore and above) against whom suits have been filed by banks and FIs for recovery of their funds, as on 31st March every year. It is our experience that these measures had not contributed to any perceptible recoveries from the defaulting entities. However, they serve as negative basket of steps shutting off fresh loans to these defaulters. I strongly believe that a real breakthrough can come only if there is a change in the repayment psyche of the Indian borrowers.

Recovery action against large NPAs

After a review of pendency in regard to NPAs by the Hon'ble Finance Minister, RBI had advised the public sector banks to examine all cases of wilful default of Rs 1 crore and above and file suits in such cases, and file criminal cases in regard to wilful defaults. Board of Directors are required to review NPA accounts of Rs.1 crore and above with special reference to fixing of staff accountability.

On their part RBI and the Government are contemplating several supporting measures including legal reforms, some of them I would like to highlight.

Asset Reconstruction Company:

An Asset Reconstruction Company with an authorised capital of Rs.2000 crore and initial paid up capital Rs.1400 crore is to be set up as a trust for undertaking activities relating to asset reconstruction. It would negotiate with banks and financial institutions for acquiring distressed assets and develop markets for such assets.. Government of India proposes to go in for legal reforms to facilitate the functioning of ARC mechanism

Corporate Debt Restructuring (CDR)

Corporate Debt Restructuring mechanism has been institutionalised in 2001 to provide a timely and transparent system for restructuring of the corporate debts of Rs.20 crore and above with the banks and financial institutions. The CDR process would also enable viable corporate entities to restructure their dues outside the existing legal framework and reduce the incidence of fresh NPAs. The CDR structure has been headquartered in IDBI, Mumbai and a Standing Forum and Core Group for administering the mechanism had already been put in place. The experiment however has not taken off at the desired pace though more than six months have lapsed since introduction. As announced by the Hon'ble Finance Minister in the Union Budget 2002-03, RBI has set up a high level Group under the Chairmanship of Shri. Vepa Kamesam, Deputy Governor, RBI to review the implementation procedures of CDR mechanism and to make it more effective. The Group will review the operation of the CDR Scheme, identify the operational difficulties, if any, in the smooth implementation of the scheme and suggest measures to make the operation of the scheme more efficient.

Credit Information Bureau

Institutionalisation of information sharing arrangements through the newly formed Credit Information Bureau of India Ltd. (CIBIL) is under way. RBI is considering

the recommendations of the S.R. Iyer Group (Chairman of CIBIL) to operationalise the scheme of information dissemination on defaults to the financial system. The main recommendations of the Group include dissemination of information relating to suit-filed accounts regardless of the amount claimed in the suit or amount of credit granted by a credit institution as also such irregular accounts where the borrower has given consent for disclosure. This, I hope, would prevent those who take advantage of lack of system of information sharing amongst lending institutions to borrow large amounts against same assets and property, which had in no small measure contributed to the incremental NPAs of banks.

Proposed guidelines on wilful defaults/diversion of funds

RBI is examining the recommendation of Kohli Group on wilful defaulters. It is working out a proper definition covering such classes of defaulters so that credit denials to this group of borrowers can be made effective and criminal prosecution can be made demonstrative against wilful defaulters.

Corporate Governance

A Consultative Group under the chairmanship of Dr.A.Ganguly was set up by the Reserve Bank to review the supervisory role of Boards of banks and financial institutions and to obtain feedback on the functioning of the Boards vis-à-vis compliance, transparency, disclosures, audit committees etc. and make recommendations for making the role of Board of Directors more effective with a view to minimising risks and over-exposure. The Group is finalising its recommendations shortly and may come out with guidelines for effective control and supervision by bank boards over credit management and NPA prevention measures.

5.2 A critical evaluation of the Policy measures to control NPAs

A discussion of NPAs reveals that two sets of factors are in action: One that leads to the emergence of NPA and the other helps in its perpetuation and does not allow the problem to be resolvedOne set of policies aims at preventing an asset from degenerating into NPA and the other set is to ensure recovery in case of default. While PSBs have their share of fault in failing to check the growth of NPAs, the more significant problem appears to be related with the asset market. It is in this context, the policy measures introduced need to be critically looked into.

In the first set of policies, the measures intended to granting a measure of autonomy subject to prudential guidelines are discussed below. These measures may be classified into two categories. One was deregulation of interest rate, while the other one related to dismantling of statutory credit allocation mechanisms.

The period prior to 1992 was characterised by administered interest rate as well as tight credit allocation mechanisms. In April 1992, steps were taken by RBI to deregulate interest rate on liabilities and assets in a phased manner. Interest rate deregulation started with deposit rate. Banks were allowed to fix deposit rates below a ceiling rate announced by RBI. Deregulation of lending rates began in October 1994 with deregulation of rates for advances greater than Rs 200,000 subject to a certain norm. The single most important event in this phase was deregulation of entry of private domestic banks through the issue of specific guidelines by RBI on 22 January 1993 as per the recommendations of Narasimham Committee. The interest rate on liabilities was further deregulated subsequently. Since July 1996, RBI had been taking steps to abolish ceiling on interest rates for deposits of different maturities, beginning with those with the maximum maturity. By April 1998 interest rate on deposits for more than fifteen days had also been freed. Banks were allowed to charge differential rates on deposits of similar maturity but of different sizes. However, interest rates on saving deposits continue to be governed by RBI. Interest rates on NRI domestic term deposits under Non-Resident (External) Rupee Accounts scheme have also been deregulated, and banks have been given the freedom to fix their own interest rates on deposit under Foreign Currency Non-Resident Accounts (Banks) scheme subject to a ceiling prescribed by the RBI from time to time. Alongside this, banks were exempted from obtaining prior approval of the RBI or prior concurrence of the IBA for introducing new deposits mobilization schemes, except for NRI deposits. However it remains obligatory for banks to obtain prior approval of their respective boards and follow the directives on interest rates, premature withdrawal, sanction of loans and advances against deposits etc issued by RBI from time to time. During this phase, deregulation of interest rate on assets was continued. After deregulating the lending rate for loans above Rs 2,00,000, lending rates for loans below Rs 200,000 have also been partially deregulated with effect from April 1998. Interest on all loans below Rs 2, 00,000 was allowed to vary up to an upper limit set by PLR. These rates were earlier fixed at 12 percent for credit up to Rs 25,000 and 13.5 percent for credits limits between Rs 25000 and Rs 2,00,000.

Deregulation in lending rates has been followed by lifting of different quantitative restrictions on credit allocation. All instructions relating to maximum permissible bank finance. and credit monitoring arrangements have been withdrawn since April 1997. Similar deregulations have also been made with respect to term finance by virtue of which RBI has withdrawn its stipulation both on time and quantum of loans that can be granted by banks either individually or in consortia for a single project. Deregulation of interest rate has provided an opportunity for banks to fix interest rates for different categories of borrowers in accordance with their risk profile. Discarding of credit allocation schemes has led to more autonomy on the part of the banks in formulating their own method of assessing working capital needs of borrowers within the prudential guidelines and exposure norms prescribed by RBI.

5.3 Problems with these policies

Monetary developments in the first half of 1998-99, as outlined in the mid-term review of the credit policy, has made it clear that there is adequate liquidity in the system and had advised the banks to step up their lending operations. However, this has not happened. Due to very stringent RBI norms on NPAs, there appears to be a universal thought process in all echelons of the banking system that it is better not to lend rather than to face the risk of NPAs. Banks are more comfortable with lending to companies with AAA or AA ratings since they do not run the risk of NPAs. This resulted in what has been termed as "islandisation of credit"

. It is a phenomenon where the credit delivery is polarised and handful of large companies with very good ratings gobble up most of the credit leaving the rest of the industrial sector high and dry. It has been observed that Corporation Bank roped in certain zero risk clients in 1999 for extending 500 crores at PLR

. However, it is argued that such a phenomenon is also fraught with problems. Denying credit to companies without top ratings has an adverse effect on the industrial production and GDP growth. This will not only stifle the companies that are deprived of credit but also harm the companies with top ratings by aggravating recession. The new banking culture, nurtured by economic and financial reforms has induced PSBs to focus on consumer credit and capital-market related activities, apart from corporate elite. Lending to agriculture, small-scale industries and the self-employment sector has become infra-dig. This illusion was shattered with the capital market becoming moribund during 2003.While, in the case of consumer lending, a sort of saturation point was reached, and the PSBs found the soft option of investing a bulk of their resources in government securities. This trend which has become a chronic feature of PSBs, has been characterised as a sort of sickness of the PSBs. It is against this backdrop, the activist role that RBI has at long last resumed playing in prodding PSBs to lend more to the rural and semi-urban areas has to be viewed. Credit policy measures announced on April 29,2003 also carries a firm tone that PSBs be dissuaded them from exercising the soft option of investing bulk of their resources in government securities. A drastic step like imposing a ceiling on

PSBs investments, say 30 percent of their NTDL has already been suggested to provoke these PSBs to reach out to the intended sectors.

To overcome the second type of problems, the steps taken by the government are to strengthen institutional framework so as to ensure speedy recovery consequent on default. After default, the only course of action left to banks is to take possession of the collateral and sell in the market at an a price covering the loan amount, interest amount and the incidental expenses. But, for utilizing of the asset market in solving problem of NPA may require the following three conditions.

1. The bank can smoothly take the possession of the asset.
2. A secondary market in the ceased asset must exist.
3. Transaction cost of operating in the market is low so that it may be used for realising a commensurate price of the collateral.

Selvam Committee framed by IBA on NPAs argued that it takes decades for courts to decide cases and even when degrees are obtained, execution of decrees are virtually an impossible task. In view of the inability of the legal system to help tackle the problem of NPAs, government set up the Debt Recovery Tribunals (DRTs henceforth) during 1994 in terms of "Recovery of Debts Due to banks and Financial Institutions Act, 1993." DRTs have been conferred jurisdiction to try and entertain application for recovery of debts due to banks and financial institutions. The jurisdiction of the civil courts has been excluded in matters falling within the jurisdiction of the Tribunal except under Articles 226 and 227 of the Constitution of India. The Debt Recovery Tribunal, which has the jurisdiction to entertain only claims from banks and financial institutions, will not have the jurisdiction to entertain a cross suit or counter-claim that may be founded either on the same or a separate cause of action and/or the amount of which may even be in excess of the claim in suit. This is because the Debt Recovery Tribunal has no jurisdiction to pass and decree or order for recovery against the bank or financial institutions.

An Appellate Tribunal has also been constituted to entertain appeals from orders of the Debt Recovery Tribunal. If a person is aggrieved by the order of the DRT, it can file an appeal to the Appellate Tribunal within 30 days from date of receipt of the DRT order. If the DRT or Appellate Tribunal holds that possession of assets by the secured creditor was wrongful and directs the secured creditor to return asset to concerned borrower, the borrower shall be entitled to compensation and costs as may be determined by DRT or Appellate tribunal. The Tribunal can also direct return of assets, if the secured creditor had already sold or transferred the asset to a third party.

However, DRTs, conceived as fast techniques for recovery of bank loans remained virtual non-starters. The reasons include inadequate infrastructure unable to handle large number of cases under DRTs, inappropriate legal framework governing the functioning of DRTs and ineffective threat of forcing recovery through DRT, when loans are not backed by assets.

A new ordinance called "Securitisation and Reconstruction of Financial Asset and Enforcement of Security Interest Act" was issued on June 21, 2003. It allowed secured lenders to sell and lease assets which are charged with them by a defaulting borrower without the lender's consent, after issuing a notice the assets are immediately classified as non performing, without a protracted legal battle. The ordinance deals with three basic issues: securitisation of assets, setting up of an asset construction company and enforcement of securities. What is being focused here is enforcement of security, which boils down to taking control of a defaulter's assets.

However it has been observed that, DRTs frequently raise objections when lenders approach them with the plea to initiate action under Securitisation Act in suit filed accounts that have been lying before the tribunals. This is an example

how two measures designed to solve the same problem run at cross purposes. The passage of the above mentioned act did not mean end of court interventions in settlement of NPA problem. The legality of the Act has been challenged by several lenders against whom banks had threatened action of seizure and sell-off assets under the powers derived from the legislation. The Supreme court had issued a stay on sale of assets under the act after Mardia Chemicals had filed a case against ICICI Bank for paying up its dues, failing which the bank had threatened recovery action under the act. Subsequently, several companies that had incurred the wrath of its lenders filed cases in the high courts challenging the notices issued to them and have obtained stay of further action.

Pending litigation blocks attachment and selling of collateral by the bank in case of default. In the meantime, the value of assets erodes faster with lengthy time taken for sale only realising junk value. After the first round of notices to big defaulters with loans up to Rs10 crores as per Securitisation Act, some banks, still reluctant to seize assets have sent a second round of notices to defaulters to come forward for compromise for settlement. Banks do not want to attach the assets of the defaulter as it has inadequate expertise in managing or disposing of those attached assets to recover its due from its defaulters. Instead it prefers to bring the provisions of Securitisation Act to bring its defaulters to the negotiation table and execute compromise deals towards early recovery of NPAs. The biggest failure of PSBs in recovering their NPA is on account of big borrowers with PSBs making recoveries of merely Rs 168 crores against NPAs under this category of Rs 22,355 crores till March 2003. This poor response of the scheme forced RBI to extend the scheme till December 31, 2003 against the earlier deadline of October 31, 2003. High value defaults with dues exceeding Rs 5 crores accounted for total NPAs of PSBs to the extent of Rs 22,866 crores, accounted for a large portion of their total Rs 56,000 crores NPAs. Quite clearly, the response of this section of defaulters is the most critical part of any attempt to significantly bring down the NPA burden of PSBs. It is felt that reluctance of the

large defaulters to come forward for settlement discussions indicates that they are probably more confident to take on the lenders if action is threatened under the Securitisation Act presumably because of political clout). Thus, political interference appears to be significant as it acts as a double-edged sword, both in creating as well as perpetuation of NPA problem.

Narasimham Committee suggested formation of an "Asset Reconstruction Fund" which will take over bad and doubtful debts from banks at a discount and subsequently follow up the recovery of dues owed to them by the primary borrowers. Having acquired bad loans, ARFs have four options to recover. They include sale of collateral, restructuring the loan, foreclosure of the loan and seizure of all the assets and going for liquidation of the company. A complexity of factors conspires against formation and consequent satisfactory operation of ARFs. They are discussed below.

a) Lack of a market in impaired financial asset

The first step towards formation of ARF is to transfer impaired financial assets from banks to the new entity. However, it has been observed that talks between banks and RBI on guidelines for ARFs appears to be stuck on the pricing of the impaired assets in the absence of a market, where such prices may be determined. ARF managers prefer to price the impaired assets net of provisioning with a view to reduce financial outgoes to the banks. Banks have not agreed to this and have expressed preference for auditors and chartered accountants to value the market price of an NPA put up on sale to the ARF. This problem is aggravated due to lack of existence of a secondary market of physical assets. This leads us the next problem.

b) Lack of a secondary market in physical asset

It appears ARCs can not be a success story in absence of secondary market in ceased asset. The problem originates due to the fact that these assets are idiosyncratic, i.e. invested for a specific purpose. Its value is realised only if it is functioning for that particular purpose. It has no value (except scrap value) for other purposes. The set of its potential buyers is highly restricted to those who can utilise this asset in a productive way, provided the asset will remain technologically viable.

c) Claims of banks preceded by that of financial institutions

There is again a legal aspect of the current standoff with regard to ARFs. As per the law, financial institutions providing long term funds have first charge on assets, with banks holding second or third charge. On current asset, the bank hold the first charge, but in the case of an NPA current asset are usually nil. In such a case, financial institutions get away with the sale proceeds of the NPA, leaving the banks in the lurch. While some bankers have argued for a pro-rata sharing of sale proceeds irrespective of the nature of the charge, RBI can not change the basic law.

The above discussion reveals that a number of conditions are necessary for operating in a secondary market for assets with a low transaction cost. They include speedy trial at lower litigation cost, getting possession of the asset, once the verdict is given in favour of the bank, lower intermediation cost.

Chapter 7

✓ Conclusions

Conclusions

It was commonly believed that the Indian government could not afford bank failure, the government would rescue the banks whatever was the level of the crisis. This caused some sort of desperation on the part of both the bankers and borrowers. The state, and RBI in particular, made concerted efforts to control it. When the new accounting practice was introduced, where interest earnings included the realised interest only, not the interest accrual, PSBs showed substantial losses and thereby a massive recapitalisation was called for. On the other hand, in order to clean off the NPAs from the balance sheet, banks had to make provisioning against these loss assets. This in turn affected their profit to a great extent putting these banks in a kind of vicious cycle.

Over the next ten years these ratios slowly declined – by 2003, gross NPAs to total advances became 9.4 percent and that in total assets became 4.2 percent. This decline was not due to recovery of the loss assets but due to faster growth of advances and assets of the banks compared to their NPAs. However, incremental NPAs in fresh advances or assets declined considerably. This may be interpreted in terms of concerted efforts made by the RBI in raising competitiveness and efficiency and in terms of granting greater autonomy to the banks in their decision-making.

However, in absolute terms, gross NPAs rapidly increased – within the ten year period, 1993-2003, it rose from Rs 39 thousand croses to Rs 54 thousand crores. While analysing the factors responsible for the massive accumulation of NPAs alternative approaches and frameworks have been used in this paper. First, formation of NPAs is seen as an integral part of banking activities and its magnitude would depend on the exposure of the banks to various levels of risks across sectors of economic activities. But, it was noted that the risks (measured by returns in terms of interest earnings) are not commensurate with the NPAs. The explanations of liberalisation and globalisation, overall economic slowdown, stagnation in many industries and agriculture leading to NPA formation, could not stand in explaining such a high share of default in total advances. Nevertheless, the above mentioned problems might have contributed towards NPA formation to an extent.

A micro-level probe would reveal that non-economic factors, like moral hazards, adverse selection, screening and monitoring problems, principal agency problems, are highly important - some of which are operating through political and bureaucratic channels and some others through banks' own administrative channels in granting loans and in preventing recovery of dues. In case of Indian PSBs this has become a rampant and all-pervasive phenomenon. In fact high incidence of default in the priority sector lending may be attributed to a great extent to the political factors. Similarly, there are ample evidence of big borrowers in the non-priority sectors who defaulted but the banks could not penalise and confiscate their assets because the latter wielded enormous political power and at times influence over the board of members of the banks. The problem of confiscation of asset was further aggravated by two important factors – legal factors that take a long time to settle any dispute, and highly imperfect or inadequately formed markets for confiscated assets. All this leads the banks to go for compromise with the defaulters giving several concessions to the latter and this encourages the others to default. The evolving policies of settlement of NPAs are being frequently thwarted by legal injunctions and are yet to be concretised.

Thus, NPA formation depends not only on banking rules, regulations and practices that are part of its institutions, but also on the external institutional environment within which PSBs operate, like the political will, cultural practices or the social customs/moral fabric of the society, and overall economic conditions. Several of these internal and external institutions have degenerated over the decades, some of which are worth mentioning.

Table 20: Growth rate of schedule commercial banks' deposits and investments in government securities

Period	Growth rate of commercial banks' deposits (%)	Growth rate and investments in government securities (%)
1970-80	20.68	21.16
1980-90	17.96	19.22
1990-2002	17.07	20.62

Till the initiation of reforms in 1992, Indian PSBs, had been operating not as an independent organization, but as if a subsidiary to the government with the objective of meeting the financial requirements of the state. They operated under the strict guidelines of the RBI, which were all encompassing. Although most of their deposit came from the private sector, i.e., households, a major part of their lending was confined to the government, and they also made substantial investment in government bills/securities as shown in the table 6. The developmental policies of the state-requiring mobilisation of a large sum of money made the state a major customer of the PSBs. RBI acted as the mediator between the state and PSBs more or less determining the amount/share of the deposit to be allocated to the state and the private sectors. For the private sector lending it fixed ceiling and floor rates of interest depending on the type of loan, size of loan, type of borrower, nature of collateral, etc. The interest rates often did not reflect the risks of lending. RBI also fixed interest rates on deposits. The bank had little room for making own decisions in adjusting interest rates with the risks of lending, especially to the private borrowers.

With frequent intervals, RBI changed CRR, SLR, and shares of loans to priority sector and other sectors, and the banks gradually learnt to adjust receiving deposits, lending and making investments accordingly. Through division of labour in the branches, banks were able to routinise things. Under this system, there was very limited scope for making profitable innovations in terms of both organisational changes and seeking new sources of fund and new avenues of investments/lending.

As stated above, for many of the private sector loans, banks were not able to match risks with interest rate restrictions imposed by the RBI. Once RBI fixed the share of loans and the rate of interest to particular sectors, banks became constrained not to discriminate among borrowers of a limited number. For a long period, real interest rates were negative for many of these loans; obviously, vested interest, political and local intervention would creep in in order to extract surplus in the system (i.e., difference between the opportunity costs and actual cost of borrowing). Since it was not mandatory on the part of the banks to declare NPA or recover loans, and since, RBI was happy so long as the banks were able to finance state expenditure, a laxity crept into the banking sector. This happened particularly for the kind of private sector lending mentioned above and, in general, profit earning/ meeting the interests of the depositors became the secondary objective of the banks. Often the non-intended borrowers received the loans, and even for the case of some target borrowers, the influential brokers who arranged the loans would take away a sizeable amount of the loan disbursed. The borrowers would not be able to repay the loans; even if they could, they would not be interested in doing so. The broker had to manipulate the system in such a way that the bank could not penalise the borrowers. On the contrary, the bank granted fresh loans to the defaulters so that the debt would roll on(known as evergreening of accounts). Under these circumstances, it was quite obvious that some personnel of the bank would also try to extract some surplus.

Thus a new institution which is degenerative of the bank evolved. The institution involved a nexus of some personnel of banks, brokers, and borrowers, that would siphon off public money through manipulating banking machinery, state machinery, mobilising political and local forces. The banks on the other hand showed this lost money, or the rolling loans, as normal assets, as if earning interests or compounding over the years. The banking institution and their institutional environment that evolved over the decades were therefore not supportive of healthy and innovative ways of making progress by the banks.

This is reflected in the functioning of the banks during the post reform period when several attempts have been made to improve upon the situation. Changes in the instruments with the banks, on the one hand, through reducing CRR, SLR, (marginally raising capital adequacy ratio), raised banks' loanable money from a given deposit, and on the other hand, considerably widening banks' freedom in their own decision making raised efficiency. Of late, state enactment provided greater power to the banks to penalise defaulters.

It was expected that all this would make the PSBs more profitable, efficient and innovative with much reduced NPA. It needs to be mentioned that the institutions are slow to change, routines are difficult to break or change. Previously, almost the entire part of the decisions was de facto guided by the state/ RBI, and the return on the compulsory lending to the state was also certain. Under the changed situation, in spite of the autonomy in decision making, PSBs could not come out of this routine behaviour of operating in a risk free environment. They invested the extra money released from reduced SLR, CRR, on government bills and securities with assured return. Their lack of innovativeness is also indicated by the late introduction of credit/debit cards, ATM facilities which private banks started much early. Possibly PSBs did it under compulsion, as the ultimate strength of a bank is its depositors who tended to move away from the PSBs.

As regards continued loan defaults and NPA, the bank routines/ rigidities, and the institutions involving nexus of borrowers, agents and bank personnel continued to be responsible even under liberalisation, RBI's insistence on reduction of NPA and more restrictive legal enactment. It is not yet mentioned that the innovations may be a routine affair and can be institutionalised. But this is not the case with the Indian PSBs. Rather it could be a case with institutions, involving the nexus of vested interests indicated above, making frequent innovations in diverting bank money for personal gain as revealed in the past when special types of fraud cases were made public. The latter institutions are very difficult to change – it not only requires stringent punitive enactment and vigilance, but also public awareness, campaign and reforming electoral colleagues. Political forces to induce default must be contained. Given the institutional features of the PSBs and their institutional environment, no radical improvement is expected from these banks within a short period whatever be the improvement in the legal structure, organizational change and the level of autonomy. These are nevertheless essential for long term improvement and for building healthy institutions albeit slowly.

Chapter 8

- ✓ Suggestions and Recommendations

Suggestions and Recommendations

The preventive and corrective measures suggested under the framework of recommendations are an indicative but not exhaustive set of guidelines relevant at banks' level. Appropriate action in respect of individual accounts may be taken keeping in view the peculiarities of the situation involved. Also, it was observed from the feedback received that a number of banks are already following some of the suggested measures in one form or the other in their NPA management. The objective underlying the exercise is to evolve a common minimum framework to tackle this problem, whilst leaving the individual banks/FIs free to formulate their own internal policies. Nevertheless, it is expected that concerned institutions will work out their strategic response in keeping with the broad thrust of these guidelines.

(i) Early Recognition of the problem:

Recognize the problem early: Invariably, by the time banks start their efforts to get involved in a revival process, it's too late to retrieve the situation - both in terms of rehabilitation of the project and recovery of bank's dues. Identification of weakness in the very beginning (i.e., when the account starts showing first signs of weakness regardless of the fact that it may not have become NPA) is imperative. Assessment of the potential of revival may be done on the basis of a techno-economic viability study. Restructuring should be attempted where, after an objective assessment of the viability and promoter's intention (and his stake), banks are convinced of a turnaround within a scheduled timeframe. In respect of totally unviable units as decided by the bank/consortium, it is better to facilitate winding up/selling of the unit early, so as to recover whatever is possible through legal means before the security position becomes worse.

Recourse to the new ordinance: The Government of India has promulgated an ordinance on June 21, 2002, called "The Securitisation and Reconstruction of financial Assets and Enforcement of Security Interest Ordinance, 2002" to facilitate foreclosure of financial assets. In respect of totally unviable units as decided by the bank/consortium, action under this ordinance may be initiated without any loss of time. Banks are also strongly encouraged to take immediate recourse to this legal remedy where they encounter malfeasance on the part of promoters/borrowers.

Early Alert System: The strategy for management of NPAs may be governed by the circumstances connected to each individual case. Generally, the NPA is more likely to be resolved in terms of recovery if the company is in operation. For this to be effective there must be a system of identifying the weakness in accounts at an early stage. Banks may put in place an "Early Alert" system that captures early warning signals in respect of accounts showing first signs of weakness. This system may be an integral part of the risk management process of the bank. Internationally, there is a similar system of "Special Mention Accounts". Depending upon the identified weaknesses, one may go back (rather than with reference to current period) to a prior or earlier period in determining the rehabilitation response.

Under the "Early Alert" system, for internal monitoring purpose, banks may designate a time limit for overdue accounts to determine the threshold for a proactive intervention - well before the account becomes NPA. This is to enable a bank to assess whether the default is due to some inherent weakness or due to a temporary liquidity or cash flow problem, and accordingly calibrate its response. For example, where there is a default in an account for 30 days, it may be shifted to a special category. Out of the accounts, ones that show promise may be considered for granting incremental facility for specific purposes, such as for capital expenditure, by ensuring strictest possible end use of the money. All the accounts displaying unsatisfactory features/early warning signals should be put under potential NPA list for follow up and time bound action to prevent their slippage. The account may be classified as potential NPA on account of one or more of the following illustrative list of features even though the account may be regular:
Delay in submission of stock statement / Other control statements / financial statements.
Return of cheques issued by borrowers. Devolvement of DPG instalments and non-payment within a reasonable period Frequent devolvement of LC and non-payment within a reasonable period. Frequent invocation of BGs and non-repayment within a

reasonable period. Return of bills / cheques discounted. Non-payment of bills discounted or under collection. Poor financial performance in terms of declining sales and profits, cash losses, net losses, erosion of net worth etc. Incomplete documentation in terms of creation / registration of charge / mortgage etc. Non-compliance of terms and conditions of sanction.

(ii) Identifying borrowers with genuine intent:

Identifying borrowers with genuine intent from those who are non- serious with no commitment or stake in revival is a challenge confronting bankers. Here the role of frontline officials at the branch level is paramount as they are the ones who have intelligence inputs with regard to promoters' sincerity, wherewithal, and capability to achieve a turnaround. Based on this objective assessment, banks should decide as quickly as possible whether it would be worthwhile to commit additional finance.

In this regard, banks may consider having 'Special Investigative Audit' of all financial transactions/business transactions, books of accounts in order to ascertain real factors that contributed to sickness of the borrower. Banks may have a panel of technical experts with proven expertise and track record for preparation of techno – economic viability study of the projects of the borrowers.

Borrowers having genuine problems due to temporary mismatch in funds flow or sudden requirements of additional funds may be entertained at the branch level, and for this purpose a special limit to tide over such contingencies may be built into the sanction process itself. This will obviate the need to route the additional funding request through the controlling offices in deserving cases, and help avert many accounts slipping into NPA category.

(iii) Timeliness and adequacy of response:

Longer the delay in response (in fact, sometimes branch officials may have to act suo-moto), greater the injury to the account and the asset. Time is a crucial element in any restructuring/rehabilitation strategy. Further, the response decided on the basis of techno-

economic study and promoter's commitment, has to be adequate in terms of extent of additional funding, relaxations etc. under the restructuring exercise. The package of assistance may be flexible, and where required, the bank may also look at the exit option.
(iv) Focus on Cash Flows:
While financing, at the time of restructuring, banks may not be guided by the conventional Funds Flow Analysis only, which could yield a potentially misleading picture. Appraisal for fresh credit requirements may be done by analysing Funds Flow in conjunction with Cash Flows rather than only on the basis of Funds Flow.

(iv) Management effectiveness:

The general perception among borrowers is that it is lack of finance that leads to sickness and NPAs. But this may not be the case all the time. Management effectiveness in tackling adverse business conditions is a very important aspect that affects a borrowing unit's fortunes. Additional finance to an ailing unit may be committed by a bank only after basic viability of the enterprise also in the context of quality of management is examined and confirmed. Where the default is due to deeper malady, viability study or Investigative audit should be done - it will be useful to have a consultant appointed as early as possible to examine this aspect. A proper techno-economic viability study must thus become the basis on which any future action can be considered.

(v) Consortium/multiple financing:

During the exercise for assessment of viability and restructuring, a pragmatic and unified approach by all the lending banks/FIs as also sharing of all relevant information on the borrower would go a long way toward overall success of rehabilitation effort. However, there is an element of risk in any restructuring exercise, given the probability of success/failure. One may expect a success rate of 50% in restructuring efforts, for it is unrealistic to expect 100% success rate.

In some default cases, where the unit is still working, the bank should make sure that it captures the cash flows (there is a tendency on part of the borrowers to switch bankers once they default, for fear of getting their cash flows forfeited), and ensure that such cash flows are used for working capital purposes. Toward this end, there should be regular flow of information among consortium members. A bank, which is not part of the consortium may not be allowed to offer credit facilities to such defaulting clients. Current account facilities may also be denied at non-consortium banks to such clients and violation may attract penal action. The Credit Information Bureau of India Ltd. (CIBIL) may be very useful for meaningful information exchange on defaulting borrowers once the setup becomes fully operational, In a forum of lenders, the priority of each lender will be different. While one set of lenders may be willing to wait for a longer time to recover its dues, another lender may have a much shorter timeframe in mind. So it is possible that the latter category of lenders may be willing to exit, even at a cost – i.e., by a discounted settlement of the exposure. Therefore, any plan for restructuring/rehabilitation may take this aspect into account.

Corporate Debt Restructuring mechanism has been institutionalised in 2001 to provide a timely and transparent system for restructuring of the corporate debts of Rs.20 crore and above with banks and FIs on a voluntary basis and outside the legal framework. Under this system, banks may greatly benefit in terms of restructuring of large standard accounts (Potential NPAs) and viable sub-standard accounts with consortium/multiple banking arrangements.

(vi) Legal and related issues:

Change in mindset regarding legal action: Legal action may be initiated once the Banks/FIs are convinced and have reached the conclusion that rehabilitation is not possible and there is no other way out. This will put pressure on the borrowers and will reduce the chances of depletion in the value of the security. In this context, the new securities ordinance, as mentioned earlier, will go a long way in developing the culture of prompt repayment of banks' / FIs' dues. Under this ordinance, substantial powers have been granted to the Banks / FIs for enforcement of securities without the intervention of the courts / tribunals. Similarly powers have been given to Banks / FIs to take over the management of business of the defaulting borrowers. With these special powers a strong message is being sent to the borrowers of Banks /FIs across the country. Banks would do well to capitalise on this message in dealing with recalcitrant borrowers and wilful defaulters.

Banks may take recourse to criminal proceedings along with civil suit where misleading information has been furnished influencing the bank's credit decision. Also in case of value-less guarantees and diversion of funds, bank may not hesitate to initiate criminal proceedings. Also borrowers may be asked to declare on oath their borrowings, assets, and all other material facts, which can be the basis for criminal action in future, if details are not found to be correct.

When considering a plan for the revival/rehabilitation, the lenders should retain the right to exercise control over the ownership/ management. This can be done by ensuring pledge of promoter's shareholding to the lenders with a right to change ownership if certain covenants/stipulations are not met.

(vii) Auditor's Responsibility:

In case any falsification of accounts on the part of the borrowers is observed by the banks/FIs, they should lodge a formal complaint against the auditors of the borrowers with the Institute of Chartered Accountants of India (ICAI) if it is observed that the auditors were negligent or deficient in conducting the audit to enable the ICAI to examine and fix accountability of the auditors.

With a view to monitoring end-use of funds, if the lenders desire a specific certification from the borrowers' auditors regarding diversion/ siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. To facilitate such certification by the auditors, the banks and FIs will also need to ensure that appropriate covenants in the loan agreements are incorporated to enable award of such a mandate by the lenders to the borrowers/auditors.

(viii) Government relief:

State Government relief (state tax waiver, subsidy etc.) in respect of accounts enjoying the same takes long time to come, thus worsening the overdue position. There is a need to work in the direction of cutting down/ reducing the time lag by closer monitoring.

While it may so happen that circumstances warrant a different course of action, the above set of guidelines may be adhered to as a broader framework for preventing slippage of NPAs.

(ix) Awareness development

There is also need to develop organisation-wide awareness about banks key-business problems including stagnant business units, strain on profitability, cost of operations, unexplored business opportunities, manpower costs, NPAS etc. This could be done by senior and top management at various key centres for all the staff to make them aware about the areas of concern for the bank with a view to seek their involvement in improving business growth and profitability. It can be said from the personal experience of the author that such sharing is always useful and trade unions' as well as employees' response to organisational improvement process is generally encouraging.

(x) Industrial relations climate

Trade unions and bank management have to identify key issues for reform in HR areas that could be crucial to meet competition. By and large, bi-partitism is well established in each bank and many contentious issues can be resolved by discussions. Tender mindedness, compromises on principles and appeasement must give way to more serious dialogue on important issues. Issues such as review of existing settlements, re-deployment of surplus staff, removal of restrictive practices, re-defining clerical and subordinate staff roles, performance appraisal of clerical staff are some of the issues that require negotiations with unions to improve productivity, work-culture and finally a smooth transition to competitive environment.

Finally, there is a need to re-define the HR roles in the bank by forging HR-business partnership. This will require very matured handling and monitoring of this critical function. In the ultimate analysis, one of the key agenda before PSBs should be to improve quality of their assets-both financial as well as human.

(xi) Effectiveness of Assets Reconstruction Companies (ARCs):

Concerns have been raised about their relevence to india. A significant percentage of the NPAs of the PSBs are in the priority sector. Loan in rural areas are difficult to colect and banks by virtue of their sheer reach are bette placed to recover these loans. Loak Adalat and Debt Recovery Tribanals are other effective mechanism to handle this task. ARCs should focus on the larger borrowers. Further, ther is need for private sector and foreign participation in ARC. Private parties will lok to active resolution of the problem and not merely regard it as a book transaction. Moving NPAs to ARCs doesn't get rid of the problem. In china, poetential investors are still worried about the risk of non-enforcement of ownership rights of the assets they purchase from the ARCs. Actions and measures have to be taken to built investor confidence.

(xii) Well-Developed Capital Markets:

Numerous paper have stressed the critically of a well developoped capital market in the restructuring process. A capital market brings liquidity and amechanism for fear of capital loans. Without this a bank may seek to postpone the NPA problem for fear of capital adwquacy problems and resort to tactics like evergreening. Monitiring by bondholders is better as they have no motive to sustain uneconomic activity. Further, the banks can manage credit risk better as it is easier to sell or securitize loans a dnegotaite credit derivetives. Indian debt market is relatively under developed and attention shoul be focused on building liquidity and volumes.

(xiii) Contextual Decision Making:

Regulation must incorporate a contextual perspective (like temporary cash flow problems) and clients should be handled in a manner which reflects true value of their assets and future potential to pay. The top management shoul delegate and back decisions of this kinf taken by middle level managers.

(xiv)Securitization:

This has been used extensively in china, Japan and Korea and has attracted international participants due to lower liquidity risks. The resolution Trust Corporation has helped the Securitization market in Asian and has taken over around $460 billion as bad assets from over 750 failed banks. Its highly standardized product appeals to a broad base. Securitization in India still in a nascent stage but has potential in area like mortgage-backed securitization. ICRA estimates the current market size to be around Rs. 3000 crores.

(xv) Realignment of Performance Metrics:

Traditional performance measures like ROE and NPA Ration are not really indicative of performance. A high volume of bad debt lending today will impact positively on ROE, asset growth and NPA Ration and only show up 5 years later as NPAs. The complexity of the balance sheet makes it impossible to desegregate the impact of these actions even if stricter disclosure norms are put in place.

Economic Value of Equity (EVE or Marke Value) is useful mechanism to handle this problem. EVE is the value of the firm if its assets are instantaneously liquidated (Assuming the availability of liquid markets). Book value vis-à-vis EVE comparison given an idea of whether the "fair" value is being reflected.

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